Management's Discussion and Analysis of Financial Condition and Results of Operations

Management's 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, 2006, profit before taxation of the Group was RMB115,918 million, representing an increase of 28.6% compared with the corresponding period of last year. Net profit was RMB80,681 million, representing an increase of space 29.4% from the corresponding period in last year. The continued improvement of the Group's operating results was primarily due to the Group's ability to take full advantage of the opportunities presented by persistently high oil prices and strong market demand by strengthening its efforts in exploration and development, the optimal use of its competitive edge in upstream activities, streamlining of its downstream product mix, unifying resources allocation, accelerating the construction and interconnection of major pipelines, the steady promotion of international operations, enhancement of operational management and the continuous efforts in technological and managerial innovations.

For the six months ended June 30, 2006, the Group's basic and diluted earnings per share was RMB0.45 (for the six months ended June 30, 2005: RMB0.35).

Comparison between the six-month period ended June 30, 2006 and the six-month period ended June 30, 2005

Consolidated Operating Results

Turnover Turnover increased 25.3% from RMB260,618 million for the six months ended June 30, 2005 to RMB326,545 million for the six months ended June 30, 2006. This was primarily due to the increases in prices and sales volumes of certain main products, namely crude oil, natural gas and certain refined products.

Operating Expenses Operating expenses increased 23.8% from RMB170,651 million for the six months ended June 30, 2005 to RMB211,252 million for the six months ended June 30, 2006. This was primarily due to an increase in the purchase costs of crude oil, feedstock oil and refined products from external suppliers and an increase in taxes other than income tax.

Purchases, Services and Other Expenses Purchases, services and other expenses increased 16.3% from RMB96,956 million for the six months ended June 30, 2005 to RMB112,758 million for the six months ended June 30, 2006. This was primarily due to (1) an increase in prices of crude oil and feedstock oil from external suppliers and an increase in the volume purchased from external suppliers in the reporting period, which resulted in an increase in the purchase costs of crude oil and feedstock oil; and (2) an increase in the prices of refined products and an increase in the volume purchased from external suppliers in the reporting period, which resulted in an increase in the purchase costs of refined products. In addition, the increase in the refined product supply operation during the reporting period also resulted in a corresponding increase in purchase expenses.

Employee Compensation Costs Employee compensation costs increased 30.2% from RMB13,052 million for the six months ended June 30, 2005 to RMB16,993 million for the six months ended June 30, 2006. This was primarily due to (1) the improvement in the Company's operating results which led to an increase in the wages and welfare expenses of staff and workers; and (2) the increase in salary surcharge as a result of an increase in the base and percentage for calculating the salary surcharge since the second half of 2005 by the PRC Government. In addition, the increase of employee compensation costs in the reporting period as compared to the first half of 2005 was also due to an increase in the number of employees resulting from an expansion in production capacity.

Exploration Expenses Exploration expenses were RMB8,750 million, essentially at the same level as RMB8,729 million for the six months ended June 30, 2005.

Depreciation, Depletion and Amortisation Depreciation, depletion and amortisation increased 12.1% from RMB26,678 million for the six months ended June 30, 2005 to RMB29,910 million for the six months ended June 30, 2006. This was primarily due to an increase in the gross carrying amount of property, plant and equipment and the average net value of oil and gas assets which led to a corresponding increase in depreciation and depletion during the reporting period.

Selling, General and Administrative Expenses Selling, general and administrative expenses increased 28.2% from RMB14,902 million for the six months ended June 30, 2005 to RMB19,104 million for the six months ended June 30, 2006. This was primarily due to (1) an increase in the transportation volume which led to an increase of freight expenses; and (2) an increase in the technological development expenses resulting from intensified technological development efforts.

Taxes other than Income Tax Taxes other than income tax increased 115.6% from RMB11,253 million for the six months ended June 30, 2005 to RMB24,259 million for the six months ended June 30, 2006. This was primarily due to (1) the imposition by the PRC government of a special levy on the petroleum exploration enterprises from March 2006 which is payable by them on the portion of income realised from the domestic sales of crude oil at prices higher than a specific level, leading to a substantial increase in the amount of taxes payable by the Company compared with the first half of 2005; (2) an increase in consumption tax and surcharges as a result of an increase in the output volume of gasoline and diesel oil; and (3) an increase in compensation fees for mineral resources due to an increase in crude oil and natural gas revenue. In addition, an increase of the natural resource tax rates by the PRC government since the second half of 2005 and the increased oil and gas output in the reporting period also contributed to the increase of natural resources tax.

Profit from Operations As a result of the factors discussed above, profit from operations increased 28.2% from RMB89,967 million for the six months ended June 30, 2005 to RMB115,293 million for the six months ended June 30, 2006.

Net Exchange Gain Net exchange gain increased from RMB18 million for the six months ended June 30, 2005 to RMB32 million for the six months ended June 30, 2006. This was primarily due to an appreciation of Renminbi against the US Dollar during the first half of this year.

Net Interest Expenses Net interest expenses increased 8.8% from RMB817 million for the six months ended June 30, 2005 to RMB889 million for the six months ended June 30, 2006. This increase reflects an increase in the carrying amount of the asset retirement obligations that incurs with the passage of time, which led to a corresponding increase in the interest expense.

Profit Before Taxation Profit before taxation increased 28.6% from RMB90,169 million for the six months ended June 30, 2005 to RMB115,918 million for the six months ended June 30, 2006.

Taxation Taxation increased 21.6% from RMB25,229 million for the six months ended June 30, 2005 to RMB30,675 million for the six months ended June 30, 2006. This was primarily due to an increase in taxable profits.

Net Profit As a result of the factors discussed above, net profit increased 29.4% from RMB62,363 million for the six months ended June 30, 2005 to RMB80,681 million for the six months ended June 30, 2006.

Segment Information

The Group is engaged in a broad range of petroleum related activities through 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 sale of petroleum and natural gas.

Turnover Turnover increased 38.8% from RMB152,024 million for the six months ended June 30, 2005 to RMB211,012 million for the six months ended June 30, 2006. This was primarily due to an increase in prices and sales volume of crude oil and natural gas. During the first half of 2006, the Group's average realised crude oil price was US$58.75 per barrel, representing an increase of 35.6% from US$43.33 per barrel for the first half of 2005.

Inter-segment sales revenue increased 40.6% from RMB121,484 million for the six months ended June 30, 2005 to RMB170,761 million for the six months ended June 30, 2006. The increase was mainly due to an increase in prices and sales volume of crude oil and natural gas.

Management's Discussion and Analysis of Financial Condition and Results of Operations

Operating expenses Operating expenses increased 37.6% from RMB62,901 million for the six months ended June 30, 2005 to RMB86,560 million for the six months ended June 30, 2006. This was mainly due to the increase in taxes other than income tax, purchase expenditure and staff costs.

Profit from Operations As a result of the factors discussed above, profit from operations increased 39.6% from RMB89,123 million for the six months ended June 30, 2005 to RMB124,452 million for the six months ended June 30, 2006.

Refining and Marketing

The Refining and Marketing segment is engaged in the refining, transportation, storage and marketing of crude oil and petroleum products.

Turnover Turnover increased 27.0% from RMB200,883 million for the six months ended June 30, 2005 to RMB255,106 million for the six months ended June 30, 2006. The increase was primarily due to an increase in prices and changes in sales volume of key refined products, of which:

Sales revenue from gasoline increased 6.3% from RMB54,570 million for the six months ended June 30, 2005 to RMB57,985 million for the six months ended June 30, 2006. The increase was mainly due to an increase in prices of gasoline. The average realised selling price of gasoline increased 21.4% from RMB3,943 per ton for the six months ended June 30, 2005 to RMB4,785 per ton for the six months ended June 30, 2006. The sales volume of gasoline dropped 12.4% from 13.84 million tons for the six months ended June 30, 2005 to 12.12 million tons for the six months ended June 30, 2006.

Sales revenue from diesel increased 24.1% from RMB81,888 million for the six months ended June 30, 2005 to RMB101,637 million for the six months ended June 30, 2006. The increase was mainly due to an increase in prices and sales volume of diesel. The average realised selling price of diesel increased 21.0% from RMB3,463 per ton for the six months ended June 30, 2005 to RMB4,191 per ton for the six months ended June 30, 2006. The sales volume of diesel increased 2.6% from 23.64 million tons for the six months ended June 30, 2005 to 24.25 million tons for the six months ended June 30, 2006.

Sales revenue from kerosene increased 37.7% from RMB3,059 million for the six months ended June 30, 2005 to RMB4,211 million for the six months ended June 30, 2006. The increase was mainly due to an increase in prices and sales volume of kerosene.

Inter-segment sales revenue increased 40.0% from RMB15,098 million for the six months ended June 30, 2005 to RMB21,142 million for the six months ended June 30, 2006. The increase was mainly due to an increase in prices and changes of sales volumes of the key refined products.

Operating expenses Operating expenses increased 30.1% from RMB206,832 million for the six months ended June 30, 2005 to RMB268,995 million for the six months ended June 30, 2006. The increase was primarily due to an increase in the expenditure on the purchase of crude oil, feedstock oil and refined products from external suppliers, and an increase in selling, general and administrative expenses. In addition, the increase in the level of supply operations of oil products during the reporting period led to a corresponding increase in operating expenses.

Loss from Operations For the six months ended June 30, 2006, there was a loss of RMB13,889 million for this segment and for the six months ended June 30, 2005, there was a loss of RMB5,949 million. The losses were mainly as a result of the effect of the macroeconomic control in China of the prices of the refined products, resulting in the selling prices of the refined products in China not in line with the selling prices of the refined products in the international market.

Management's Discussion and Analysis of Financial Condition and Results of Operations

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 increased 6.8% from RMB37,035 million for the six months ended June 30, 2005 to RMB39,565 million for the six months ended June 30, 2006. The increase was mainly due to the increase in prices and sales volume of certain chemical products (primarily polyethylene and polypropylene products).

Operating expenses Operating expenses increased 17.2% from RMB31,279 million for the six months ended June 30, 2005 to RMB36,657 million for the six months ended June 30, 2006. The increase was mainly due to an increase in the prices of raw materials.

Profit from Operations Due to a significant increase in operating expenses, profit from operations decreased 49.5% from RMB5,756 million for the six months ended June 30, 2005 to RMB2,908 million for the six months ended June 30, 2006.

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 53.6% from RMB11,874 million for the six months ended June 30, 2005 to RMB18,233 million for the six months ended June 30, 2006. The increase was primarily due to an increase in the sales volume and price of natural gas and an increase in the sales volume and the average price of pipeline transmission of natural gas.

Operating expenses Operating expenses increased 31.3% from RMB10,396 million for the six months ended June 30, 2005 to RMB13,646 million for the six months ended June 30, 2006. The increase was mainly due to an increase in gas purchase expenses and an increase in depreciation charges.

Profit from Operations As a result of the factors discussed above, profit from operations increased 210.4% from RMB1,478 million for the six months ended June 30, 2005 to RMB4,587 million for the six months ended June 30, 2006.

Liquidity and Capital Resources

For the six months ended June 30, 2006, the Group's primary sources of funds were cash generated from operating activities, short-term borrowings and long-term borrowings. The Group's funds were used for operating activities, capital expenditures, repaying short-term and long-term borrowings, acquisition of subsidiaries and distribution of dividends to shareholders of the Company.

As at June 30, 2006, short-term debts represented approximately 5.1% of the Group's capital employed as compared with approximately 4.7% as at December 31, 2005. Our ability to obtain adequate financing may be affected by our financial position and operating results and the conditions of the domestic and foreign capital markets. The Company must seek approvals from the relevant PRC government authorities before raising funds in the domestic and foreign capital markets. In general, the Company 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.

The Group plans to fund its 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, 2006, net cash generated from operating activities was RMB100,825 million. As at June 30, 2006, the Group had cash and cash equivalents of RMB92,630 million. Cash and cash equivalents were mainly denominated in Renminbi (Renminbi accounted for approximately 96.8%, US Dollar accounted for approximately 2.8%, and HK Dollar accounted for 0.4%).

The table below sets forth its cash flows for the six months ended June 30, 2006 and June 30, 2005 and our cash and cash equivalents at the end of each period.

	Six months ended June 30	
	2006	**2005**
	(RMB million)	**(RMB million)**
Net cash generated from operating activities	100,825	98,167
Net cash used for investing activities	(51,974)	(5,430)
Net cash used for financing activities	(37,291)	(33,024)
Currency translation difference	165	(119)
Cash and cash equivalents at the end of each period	92,630	71,282

Cash flows from operating activities

In the first half of 2006, the Group's net cash from operating activities increased 2.7% from RMB98,167 million for the six months ended June 30, 2005 to RMB100,825 million for the six months ended June 30, 2006. This was mainly due to an increase in profit which gave rise to an increase in cash flows generated from operating activities. In addition, an increase in inventories partly offset the cash flows generated from operating activities.

As at June 30, 2006, our working capital was RMB47,930 million. As at December 31, 2005, our working capital was RMB22,057 million. The increase in working capital was primarily due to an increase in receivables and prepayments, inventories and cash and cash equivalents.

Cash used for financing activities

The Group's net cash used for financing activities increased 12.9% for the six months ended June 30, 2006 compared with the amount as at the six months ended June 30, 2005. This was mainly due to more cash dividends paid in respect of the ordinary shares for the first half of this year as compared with the corresponding period of last year.

The table below sets out our net borrowings as at June 30, 2006 and December 31, 2005:

	June 30, 2006	December 31, 2005
	(RMB million)	(RMB million)
Short-term borrowings (including current portion of long-term borrowings)	34,004	28,689
Long-term borrowings	35,804	44,570
Total borrowings	69,808	73,259
Less:		
Cash and cash equivalents	92,630	80,905
Net borrowings	(22,822)	(7,646)

The maturity profile of the long-term borrowings (including maturity within one year) of the Group is as follows:

	June 30, 2006	December 31, 2005
	(RMB million)	(RMB million)
To be repaid within one year	20,188	15,325
To be repaid within one to two years	9,981	18,373
To be repaid within two to five years	14,124	14,942
To be repaid after five years	11,699	11,255
	55,992	59,895

Of the total borrowings of the Group as at June 30, 2006, approximately 28.6% were fixed-rate loans and approximately 71.4% were floating-rate loans. Of the borrowings as at June 30, 2006, approximately 74.7% were denominated in Renminbi, approximately 23.8% were denominated in US Dollars, approximately 0.6% were denominated in Singapore Dollars, approximately 0.4% were denominated in Euro, approximately 0.2% were denominated in Japanese Yen, approximately 0.2% were denominated in Kazakhstan Tenge and approximately 0.1% were denominated in British Pound Sterling.

As at June 30, 2006, borrowings owed to China Petroleum Finance Company Limited ("CP Finance") amounted to RMB26,040 million. Borrowings owed to state-owned banks and other non-bank state-owned financial institutions amounted to RMB33,766 million and borrowings owed to other related parties amounted to RMB61 million.

As at June 30, 2006, short-term borrowings and long-term borrowings owed by the Group to CP Finance amounted to RMB300 million and RMB25,740 million respectively.

As at June 30, 2006, borrowings of the Group consisted of RMB698 million secured borrowings (RMB1,108 million as at December 31, 2005), most of which were secured by part of the Group's assets and time deposits with maturities over one year.

As at June 30, 2006, the debt to capitalisation ratio (debt to capitalisation ratio = total debts / (total debts + total equity)) was 10.5% (11.9% as at December 31, 2005).

Capital Expenditures

The table below sets out our capital expenditures by business segments for the six months ended June 30, 2006 and the six months ended June 30, 2005 and the estimates for the full year of 2006. During the first half of 2006, capital expenditures increased 41.6% from RMB33,375 million for the six months ended June 30, 2005 to RMB47,252 million for the six months ended June 30, 2006. The increase in capital expenditure was primarily due to increased contribution to oil and gas exploration and development as well as safety and environmental protection. Furthermore, the increase in the prices of fuel oil, water and electricity and other production materials, also led to an increase in investment.

	First Half of 2006		First Half of 2005		Estimate for the year of 2006	
	(RMB million)	%	(RMB million)	%	(RMB million)	%
Exploration and Production	32,933*	69.7	22,413*	67.2	100,100*	60.3
Refining and Marketing	6,169	13.1	4,614	13.8	29,000	17.5
Chemicals and Marketing	3,938	8.3	2,633	7.9	15,900	9.6
Natural Gas and Pipeline	3,840	8.1	3,651	10.9	17,100	10.3
Other	372	0.8	64	0.2	3,900	2.3
Total	47,252	100.0	33,375	100.0	166,000	100.0

* 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 2005 and the first half of 2006, and the estimate of the same for the entire 2006 would be RMB26,012 million, RMB37,253 million and RMB111,500 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, 2006, capital expenditures in relation to exploration and production amounted to RMB32,933 million, including RMB4,251 million for exploration activities and RMB26,061 million for development activities. For the six months ended June 30, 2005, capital expenditures in relation to this segment totalled RMB22,413 million, including RMB4,032 million for exploration activities and RMB16,869 million for development activities. The increase in capital expenditures was mainly due to the Group's increased expenditures relating to oil and gas development and supporting projects on the ground.

It is estimated that for the twelve months ending December 31, 2006, capital expenditures of the Group in the Exploration and Production segment will amount to RMB100,100 million. Approximately RMB20,000 million is expected to be used for oil and gas exploration, and approximately RMB80,100 million will be used for oil and gas development. Exploration and development is expected to be mainly carried out in the Erdos, Junggar, Tarim, Songliao, Sichuan, Bohai Bay, and Qaidam basins.

Refining and Marketing

For the six months ended June 30, 2006, capital expenditures of the Group in the Refining and Marketing segment amounted to RMB6,169 million, of which RMB2,935 million was spent on upgrading our refining facilities, and RMB2,041 million was spent on the expansion of the retail marketing network of our refined products and oil products storage infrastructure facilities. For the six months ended June 30, 2005, capital expenditures for this segment totalled RMB4,614 million. The increase in capital expenditures was primarily due to the construction and expansion of refining facilities.

It is estimated that capital expenditures of the Group for the Refining and Marketing segment for the twelve months ending December 31, 2006 will amount to RMB29,000 million, including approximately RMB19,300 million to be spent on construction and expansion of refining facilities, and approximately RMB9,700 million to be spent on our refined products marketing network.

Chemicals and Marketing

For the six months ended June 30, 2006, capital expenditures in the Chemicals and Marketing segment were RMB3,938 million, compared with RMB2,633 million for the six months ended June 30, 2005. The increase in capital expenditures was mainly due to increased investments in the ethylene projects of Lanzhou Petrochemical Company and Dushanzi Petrochemical Company.

It is estimated that for the twelve months ending December 31, 2006, capital expenditures of the Group in the Chemicals and Marketing segment will amount to RMB15,900 million. The capital expenditures are expected to be used primarily for construction relating to the ethylene projects of Lanzhou Petrochemical Company and Dushanzi Petrochemical Company and the PTA project of Liaoyang Petrochemical Company.

Natural Gas and Pipeline

For the six months ended June 30, 2006, capital expenditures in the Natural Gas and Pipeline segment amounted to RMB3,840 million. RMB3,494 million of these expenditures was spent on construction of long distance pipelines and RMB2,351 million of such amount was spent on the West-East Gas Pipeline project. For the six months ended June 30, 2005, capital expenditures for this segment totalled RMB3,651 million. The capital expenditures during this period were basically the same as that during the corresponding period of last year.

It is estimated that the Group's capital expenditures in Natural Gas and Pipeline segment for the twelve months ending December 31, 2006 will amount to RMB17,100 million. These capital expenditures are expected to be mainly used for the expansion of the West-East Gas Pipeline, and the construction of underground gas tanks and crude oil and refined products transmission pipelines.

Other

The Group's capital expenditures in the Other segment for the six months ended June 30, 2006 and for the six months ended June 30, 2005 were RMB372 million and RMB64 million respectively. These capital expenditures were mainly used for non-segment-specific equipment purchases.

It is estimated that the Group's capital expenditure in the Other segment for the twelve months ending December 31, 2006 will amount to RMB3,900 million. These capital expenditures are expected to be mainly used for research and development and the implementation of information systems.

Material Investment

For the six months ended June 30, 2006, the Group did not hold any material investment.

Material Acquisition or Disposal

Pursuant to the resolution passed at the meeting of the Board of Directors held on October 26, 2005, the Company offered to acquire all of the 150,000,000 outstanding A shares of Jinzhou Petrochemical Company Limited ("JPCL") from minority shareholders at RMB 4.25 per share. As at June 30, 2006, the Company had paid a total cash consideration of RMB 602 million and acquired 141,497,463 A shares, representing approximately 17.97% of the total issued shares of JPCL. Upon this acquisition, the Company owns 98.92% of the outstanding shares of JPCL. The excess of the cost of purchase over the carrying value of the underlying assets and liabilities acquired was recorded in equity. As approved by the China Securities Regulatory Commission, JPCL was delisted from the Shenzhen Stock Exchange on January 4, 2006.

Pursuant to the resolution passed at the meeting of the Board of Directors held on October 26, 2005, the Company offered to acquire all of the 200,000,000 outstanding A shares and 964,778,000 H shares (including ADS) of Jilin Chemical Industrial Company Limited ("JCIC") from minority shareholders at RMB 5.25 per A share and HK$2.80 per H share respectively. As at June 30, 2006, the Company had paid a total cash consideration of RMB 3,719 million and acquired 186,623,617 A shares and 938,751,999 H shares (including ADS), representing approximately 31.60% of the total issued shares of JCIC. Upon this acquisition, the Company owns 98.89% of the outstanding shares of JCIC. The excess of the cost of purchase over the carrying value of the underlying assets and liabilities acquired was recorded in equity. JCIC was delisted from HKSE and the New York Stock Exchange on January 23, 2006 and February 15, 2006, respectively. As approved by the China Securities Regulatory Commission, JCIC was delisted from the Shenzhen Stock Exchange on February 20, 2006.

Pursuant to the resolution passed at the meeting of the Board of Directors held on October 26, 2005, the Company offered to acquire all of the 200,000,000 outstanding A shares of Liaohe Jinma Oilfield Company Limited ("LJOCL") from minority shareholders at RMB 8.80 per share. As at June 30, 2006, the Company had paid a total cash consideration of RMB 1,713 million and acquired 194,360,943 A shares, representing approximately 17.67% of the total issued shares of LJOCL. Upon this acquisition, the Company owns 99.49% of the outstanding shares of LJOCL. The excess of the cost of purchase over the carrying value of the underlying assets and liabilities acquired was recorded in equity. As approved by the China Securities Regulatory Commission, LJOCL was delisted from the Shenzhen Stock Exchange on January 4, 2006.

Post-Balance Sheet Events

On August 23, 2006, the Board of Directors of the Company approved the entering into the acquisition agreement whereby CNPC E&D will acquire a 67% ownership interest in PetroKazakhstan Inc. ("PKZ") from CNPC International Ltd. ("CNPCI", a subsidiary of CNODC). Currently, PKZ is 67% and 33% owned by CNPCI and JSC National Company Kazmunaigaz ("KMG") respectively. A total cash consideration for this acquisition is expected to be approximately US$2,735 million. Upon completion of the acquisition agreement, PKZ will be accounted for as an associate of the Company as it is under the joint control by CNPC E&D and KMG.

Foreign Exchange Rate Risk

From July 21, 2005, the PRC government has reformed the Renminbi exchange rate regime and implemented a regulated floating exchange rate regime based on market supply and demand with reference to a basket of currencies. However, Renminbi is still regulated in capital account. The exchange rates of Renminbi are affected by domestic and international economic developments and political conditions, and supply and demand for Renminbi. Future exchange rates of Renminbi against other currencies could vary significantly from the current exchange rates. As Renminbi is the functional currency of the Company and most of its consolidated entities, the fluctuation of the exchange rate of Renminbi may have positive or negative impacts on the operating results of the Group. An appreciation of Renminbi against US Dollar may decrease the Group's turnover, but the cost for acquiring imported materials and equipment may also be reduced. A devaluation of Renminbi against US Dollar may not have a negative impact on the Group's turnover but may increase the cost for acquiring imported materials and equipment as well as the debt obligations denominated in foreign currencies of the Group.

Commodity Price Risk

The Group is engaged in a wide range of petroleum-related activities. The oil and gas markets are affected by global and regional demands and supplies. Prices of onshore crude oil are determined with reference to the prices of crude oil on the international markets. A decline in the prices of crude oil and refined products could adversely affect the Group's financial position. The Group historically has not used commodity derivative instruments to hedge against potential price fluctuations of crude oil and refined products. Therefore, the Group is exposed to general price fluctuations of oil and gas commodities in 2006 and in future years.

Industry Risk

Like other oil and natural gas companies in China, the Group's operating activities are subject to regulation and control by the PRC government in many aspects. This regulation and control, such as the granting of exploration and production licenses, the imposition of industry-specific taxes and levies and the implementation of environmental and safety standards are expected to have an impact on the Group's business operations. As a result, the Group 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 oil and natural gas industry may also affect the Group's business operations.

Employees and Employees Compensation

Number of Employees

As at June 30, 2006 and June 30, 2005, the Group had 438,127 and 423,200 employees respectively. The table below sets out the number of employees of business segments as at June 30, 2006:

	Number of Employees	Percentage of total (%)
Exploration and Production	246,969	56.4
Refining and Marketing	117,799	26.9
Chemicals and Marketing	58,583	13.4
Natural Gas and Pipeline	10,776	2.4
Other*	4,000	0.9
Total	438,127	100.0

*Note: Including staff of the Company headquarters, specialised entities, Exploration & Development Research Institute, Planning & Engineering Institute and Petrochemical Technological Research Centres.

Employee Compensation

The total employee compensation payable by the Group for the six months ended June 30, 2006 was RMB11,198 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 realisation of the best results.

The Company's senior management remuneration system links senior management members' financial interests (including those of executive directors and supervisors) with the Company's operating results and the market performance of its shares. All 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 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
Department general manager	25	50	25

Details of the emoluments of directors and supervisors for the six months ended June 30, 2006 and June 30, 2005 are as follows:

	For the six months ended June 30	
	2006	2005
	(RMB'000)	(RMB'000)
Emoluments of directors and supervisors	816	62
Salaries, allowances and other benefits	985	927
Contribution to retirement benefit scheme	28	28
	1,829	1,017

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, 2006	As at June 30, 2005
	Number	Number
Nil ~ RMB1,000,000	20	20

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.

Training Programmes

The training programmes of the Company for 2006 have been geared towards achieving the development strategy and operation objectives of the Company. In line with the strategic requirement for "a strong corporation with highly talented personnel", the Company has targeted high-calibre, skilful and international staff in its training programmes with a focus on the training of the "core" and "backbone" personnel and strived to build a proficient operating and management team, a technology innovative team and a skilful operators' team to ensure the supply of talents required for the continuous and stable development of the Company.

Contingent Liabilities

Information on the Group's contingent liabilities as at June 30, 2006 is as follows:

Bank and other guarantees

As at June 30, 2006, the Group had contingent liabilities in respect of guarantees made to CP Finance, a subsidiary of CNPC, and state-controlled bank from which it is anticipated that no material liabilities will arise.

	June 30, 2006	December 31, 2005
	(RMB million)	(RMB million)
Guarantee of borrowings of associates from CP Finance	176	187
Guarantee of borrowings of third party from State-controlled bank	41	-
	217	187

Environmental Liabilities

CNPC and the Group have operated in China for many years. China has adopted extensive environmental laws and regulations that affect the operation of the oil and gas industry. The outcome of environmental liabilities under proposed or future environmental legislation cannot reasonably be estimated at present, and could be material. Under existing legislation, however, 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, management believes that any resulting liabilities will not have a material adverse effect on the financial position of the Group.

Leasing of land, roads and buildings

According to the restructuring agreement entered into between the Company and CNPC in 1999 upon the 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, 2006, CNPC has obtained formal land use right certificates in relation to 27,400 out of the above-mentioned 28,649 parcels of land and some building ownership certificates for the above-mentioned buildings, but has completed none of 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 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, 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.

Others

On November 13, 2005, explosions occurred at a manufacturing facility of a branch of the Company located in the Jilin Province. The impact of the accident is undergoing government investigation. The Company is presumed to bear related liability according to the investigation results.