

Business Operating Review and Prospects

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Market Review

Crude Oil Market Review

During the first half of 2006, international crude oil prices remained at high levels due to rapidly expanding demand, insufficient residual supply of crude oil, intensified geo-political risk, speculation and other factors. The average prices for WTI, Brent and Minas crude oil in the first half of the year were US\$66.80, US\$65.65 and US\$65.81 per barrel respectively, representing an increase of US\$15.31, US\$16.00 and US\$14.94 per barrel or 29.7%, 32.2% and 29.4% respectively from the corresponding period in last year. Corresponding to the rise in international oil prices, domestic crude oil prices also increased. The average realised price was higher than that of the first half of 2005.

Domestic crude oil imports continued to increase during the first half of 2006 with net import volume of 70.33 million tons, representing an increase of 17.6% from the corresponding period in last year. Domestic crude oil output and the amount of crude oil processed reached 92.10 million tons and 142 million tons respectively.

Refined Products Market Review

During the first half of 2006, although the PRC government strengthened its control on the domestic macroeconomy, demand for refined products still remained relatively high. In general, resources were tight and market prices continued to rise and hit new historical highs repeatedly. In the first half of the year, nominal consumption of refined products increased 7.1% to 85.73 million tons compared with the corresponding period in last year. By the end of June 2006, the refined products inventory held by the Company and Sinopec reached 7.88 million tons, representing an increase of 0.54 million tons from the corresponding period in last year.

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The PRC government has made certain adjustments to the prices of domestic refined products during the first half of 2006. However, under the impact of international oil prices, the average benchmark prices of gasoline and diesel were still higher than their levels during the corresponding period of last year.

Chemical Products Market Review

In the first half of 2006, the sustained rapid economic development in China resulted in strong demand of chemical products. Market supply of crude oil was unable to satisfy the increase in demand due to strong demand, limited increase in supply and the overhaul of facilities. In a climate of persistently high crude oil prices, chemical products market tended to favour the sellers and the prices of most chemical products achieved a 10-year record high.

Natural Gas Market Review

In the first half of 2006, China's natural gas market has continued to show a trend of rapid growth. Despite the adoption by the PRC government of a new pricing regulation for natural gas in December 2005 and further raising the ex-factory price of natural gas in China, the demand for natural gas has been growing at an excessive rate and the discrepancy between its supply and demand remained prominent.

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For the six months ended June 30, 2006, total oil and gas output of the Group was 533.2 million barrels of oil equivalent, including 419.1 million barrels of crude oil and 684.7 billion cubic feet of marketable natural gas, representing an average daily crude oil output of 2.32 million barrels and an average daily marketable natural gas output of 3,783 million cubic feet. A total of 417 million barrels of crude oil and 653.5 billion cubic feet of natural gas were sold during the six months ended June 30, 2006. The Group sold approximately 84.8% of its crude oil to its refineries. During the first half of 2006, lifting cost of the Group was US\$5.91 per barrel, compared with the lifting cost of US\$5.10 per barrel in the first half of 2005.

For the six months ended June 30, 2006, the Group's refineries processed 393 million barrels of crude oil, representing an average daily processed output of 2.17 million barrels. The Exploration and Production segment provided approximately 83.0% of the crude oil processed by the Group's refineries. The Group produced approximately 34.30 million tons of gasoline, diesel and kerosene and sold approximately 37.35 million tons of these products. The Group is actively expanding its sales network, and its retail network in

particular, by taking advantage of the complementary value-added effect of the integration of Refining and Marketing segment. As at June 30, 2006, there were 17,952 service stations either owned, controlled or franchised by the Group or owned by CNPC but to which the Group provided supervisory support. The cash processing cost of the Group's refineries has arisen from RMB126 per ton during the first half of 2005 to RMB151 per ton for the same period of 2006.

For the six months ended June 30, 2006, the Group produced 1.003 million tons of ethylene, 1.525 million tons of synthetic resin, 0.628 million tons of synthetic fibre raw materials and polymers, 0.155 million tons of synthetic rubber, and 1.737 million tons of urea.

The Natural Gas and Pipeline segment is the Group's core business segment for development. For the six months ended June 30, 2006, the Group sold 566.8 billion cubic feet of marketable natural gas through its Natural Gas and Pipeline segment. As at June 30, 2006, the Group owned and operated 20,340 kilometers of regional natural gas pipeline network, of which 19,212 kilometers of the pipeline network were operated by the Natural Gas and Pipeline segment. The Group owned and operated 9,391 kilometers of crude oil pipeline and owned 2,460 kilometers of refined products pipeline.

The Second Half of 2006 and Beyond

In the first half of 2006, in an environment characterised by strong domestic demand for oil and gas, the Company advanced its main operations in an active and orderly manner and improved the micro-management of its production. As a result, the principal production and operation targets were achieved and new breakthroughs occurred in various aspects of operations. Various significant achievements were made in the efforts of oil and gas exploration, leading to a sustainable increase in oil and gas reserves of the Company. Crude oil processing volume has achieved steady growth which further improved the major techno-economical indices. The Company strived to produce more value added products in its chemical production, leading to an effective increase in the competitiveness of its major products. The construction of major oil and gas pipelines was progressing smoothly and certain key projects have been completed and have commenced operations.

In the second half of 2006, the Company anticipates that it will continue to enjoy a generally favorable macroeconomic environment. The Company plans to steadily coordinate its production and business operations according to the work plans formulated at the beginning of the year. The Company plans to continue "prioritising safety and environment and people orientation", further strengthen safety and environmental protection, emphasise the creation of corporate harmony and actively fulfill its social duties. The Company aims to fully achieve the annual performance targets to promote its sustainable, effective and rapid growth.

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In the Exploration and Production area, the Company plans to speed up the implementation of oil and gas exploration plans and actively promote the steady growth of crude oil output and rapid growth of natural gas output; put special emphasis on petroleum exploration, intensify natural gas exploration and promote risk explorations in key basins and favorable regions; strengthen the comprehensive management of mature oilfields, enlarge production capacity in new regions and carefully coordinate production and operations as well as the linkage and management of different stages of operations; ensure that the annual targets of oil and gas reserves volume and production plans will be achieved.

In the Refining and Marketing area, the Company plans to steadily coordinate refining and production, and consistently improve marketing quality and returns; further optimise the overall refining layout to ensure that key refining construction projects are implemented as scheduled; strengthen the management of the overall control of the production process, improve the stability rate and effective rate of the operation of facilities to ensure safe and reliable production; improve the linkage of production, transportation and marketing, enlarge end-user sales volume and improve sales quality and operation returns; leverage on the strength of integrated refining, continue to improve the chemical product mix and increase the proportion of high quality and high value added products, aiming to maximise the overall returns.

In the Natural Gas and Pipeline area, the Company plans to organise natural gas production and marketing in a systematic manner, steadily and gradually increase the construction of major pipelines. The Company plans to proactively grasp the changes in the use of gas in downstream industries, further strengthen the balance among production, transmission and sales of natural gas and enhance safe operation of pipelines.

In its international operations, the Company plans to steadily promote international business and expand international cooperation, continue to increase exploration in key regions and actively promote risk explorations; further develop overseas business, coordinate production in existing regions in full gear to ensure that the annual targets of oil and gas operational output and share oil output will be achieved. The Company plans to promote international trade by actively diversifying imports of resources, consistently improving trading methods and trading system to enhance the total trade volume and improve profitability.

In the future, the Company intends to continue seeking to maximise its returns and value for its shareholders, emphasise main businesses, and continue developing international businesses and promoting rapid growth in international operations while intensifying domestic oil and gas exploration and development and solidifying the resource base. The Company plans to continue to maintain its steady, credible and responsible operation style, and improve corporate governance and continuously increase corporate value by strengthening internal control and operations management.