Management Discussion and Analysis

1. Discussion and analysis of the overall operation during the reporting period

The following discussion and analysis should be read in conjunction with the unaudited financial statements of the Group and notes in the interim report. The financial data involved hereinafter are extracted from the unaudited financial statements prepared in accordance with IFRS.

The global economy advanced better than expected in the first half of 2006 and as a result, the United Nations and some international organizations have made upward adjustments to their forecasts on global economic growth for 2006. China's economy maintained its steady and rapid growth, with the GDP rising by 10.9% in the first half of the year. Attributed to a number of factors such as repeated new highs in rising international crude oil prices, persistently rapid growth of the domestic economy and successive commencements of production of new and expanded petrochemical facilities, production and sales in both the petroleum and chemical industries in China continued to thrive in the first half of the year, realizing more than 25% increase in income from product sales and total profits for the whole industry. However, various sectors of the whole industry performed quite differently, as witnessed by a growth mainly driven by the exploitation of crude oil and natural gas and declining profits or even increasing losses registered by synthetic materials manufacturing and crude oil processing.

Business review and discussion on the operating results

In the first half of 2006, the Group strived to capitalize on the opportunities arising from the overall steady and rapid growth of the PRC domestic economy in general and the petrochemical industry in particular. Despite rising international crude oil prices, repeated new highs in crude oil prices, surging prices of raw materials, fuels and electric power in China, a slowdown in price increases with respect to petrochemical products and the adjustments in prices of petroleum products had not reflected the rising prices of international crude oil, the Group remained committed to the market-based and efficiency-focused approach by further optimizing production operation, carrying out industrial restructuring, enhancing internal management and accelerating internal reform programs. In the first half of the year, the Group was able to maintain smooth production and operations without encountering any major incidents in production, safety or environmental protection. The period of time spent on unscheduled production suspension was cut substantially, while the output-to-sales ratio for products and the receivable recovery ratio were maintained at satisfactory levels. However, performance dropped substantially as compared to the corresponding period of the previous year due to the above factors, in particular, the impact of the fact that the prices of petroleum products are subject to the State's controls and are not in line with the movement in crude oil prices. For the six-month period ended 30 June 2006, the Group's income from principal operations amounted to RMB 23,440.3 million (equivalent to HK$22,770.8 million), representing an increase of RMB1,553.8 million (equivalent to HK$1,509.4 million) as compared to the corresponding period of the previous year, up 7.10%. A profit before taxation of RMB52.7 million (equivalent to HK$51.2 million) was realized, down 97.56% as compared to the corresponding period of the previous year. Profit after taxation and minority interests amounted to RMB5.7 million (equivalent to HK$5.5 million), down 99.68% as compared to the corresponding period of the previous year.

In the first half of 2006, the Group processed 4,447,100 tons of crude oil (of which 76,800 tons were sub-contracting processed crude oil), a decrease of 6.98% or 333,700 tons as compared to the corresponding period of the previous year. Of the total processed amount, imported oil and offshore oil amounted to 4,343,100 tons and 104,000 tons, respectively. The output of gasoline amounted to 400,600 tons, a decrease of 4.08% as compared to the corresponding period of the previous year. The output of diesel amounted to 1,329,100 tons, a decrease of 17.05% as compared to the corresponding period of the previous year. Production of jet fuel amounted to 252,600 tons, a decrease of 30% as compared to the corresponding period of the previous year. The output of ethylene amounted to 480,300 tons, a decrease of 2.21% as compared to the corresponding period of the previous year. Production of propylene amounted to 263,700 tons, an increase of 0.30% as compared to the corresponding period last year. The output of synthetic resins and plastics amounted to 556,000 tons, an increase of 5.12% as compared to the corresponding period of the previous year. The output of synthetic fibre monomers and synthetic fibre polymers amounted to 382,100 tons and 300,000 tons, respectively, representing increases of 3.20% and 4.44%, respectively, as compared to the corresponding period of the previous year. The output of synthetic fibres amounted to 170,800 tons, a decrease of 4.89% as compared to the corresponding period last year. The Group's product-to-sale ratio in the first half of the year was 99.80% and the receivable recovery ratio was 99.12%.

The following table sets forth the Group's sales volumes and net sales, net of sales taxes and surcharges, for the reporting period:

	For the six-month period ended 30 June					
	2006			2005		
	Sales Volume	**Net Sales**		Sales volume	Net Sales	
		Millions	**% of**		Millions	% of
Self-produced products	**'000 tons**	**of RMB**	**Total**	'000 tons	of RMB	Total
Synthetic fibres	**174.7**	**2,306.0**	**9.97**	180.8	2,438.5	11.34
Resins and plastics	**791.8**	**7,588.2**	**32.82**	734.6	6,900.5	32.08
Intermediate petrochemical products	**485.3**	**3,039.1**	**13.14**	530.6	3,463.6	16.11
Petroleum products	**2,370.8**	**8,795.5**	**38.04**	2,604.5	8,035.9	37.36
Trading and All others	**-**	**1,395.5**	**6.03**	-	669.8	3.11
Total	**3,822.6**	**23,124.3**	**100.00**	4,050.5	21,508.3	100.00

In the first half of 2006, the Group realized net sales of RMB23,124.3 million, an increase of 7.51% as compared to the corresponding period of the previous year, in which net sales derived from petroleum products, and resins and plastics increased by 9.45% and 9.97%, respectively, and net sales of intermediate petrochemicals and synthetic fibres decreased by 12.26% and 5.43%, respectively. This was mainly due to continued increases in the prices of energy and raw materials and the upward price adjustments for petroleum products have pushed up the average sales prices of petroleum products, resins and plastics, but the increase in sales prices was lower than the price increase in energy and raw materials; and there was a slight decrease in the average sales prices of intermediate petrochemicals and synthetic fibres. Compared to the first half of 2005, the average prices (excluding tax) of the Group's petroleum products, and resins and plastics increased by 20.24% and 2.02%, respectively, and the average prices (excluding tax) of intermediate petrochemicals and synthetic fibres decreased by 4.07% and 2.13%, respectively, during the reporting period.

A majority of the Group's products are sold in eastern China.

In the first half of 2006, the Group's cost of sales increased by 21.01% to RMB22,931.8 million as compared to the corresponding period of the previous year, and it accounted for 99.17% of the net sales.

Crude oil is the Group's major raw material. Under the impact of continued growth in global demand, limited capabilities to increase output by major oil producing countries, a rise in geo-political tension, the impact of the US dollar exchange rates and trading activities of speculative funds, prices of international crude oil reached a record high and fluctuated at a high level during the year. As a result, the weighted average cost of crude oil increased by RMB830.98 per ton from the corresponding period of the previous year to RMB3,706.77 per ton in the first half of 2006, representing an increase of 28.90% as compared to the corresponding period of the previous year. The increase in average crude oil prices has resulted in an increase in the Group's total cost of crude oil processed to RMB16,199.7 million, an increase of 22.68% as compared to the corresponding period of the previous year. The cost of crude oil of the Group accounted for 70.64% of cost of sales.

Expenses for other ancillary materials amounted to RMB3,692.2 million in the first half of 2006, an increase of 8.56% as compared to the corresponding period of the previous year, which was primarily due to increases in the prices of raw materials and the volume of intermediate petrochemicals purchased to meet production needs. Depreciation and maintenance costs during the reporting period amounted to RMB914.8 million and RMB355.6 million, respectively, a slight increase as compared to the corresponding period of the previous year. Energy and power costs amounted to RMB509.3 million, an increase of RMB72.9 million as compared to the corresponding period of the previous year, which was due to increases to various degrees in both purchase volumes and purchase prices of thermal coal and external electricity as compared to the corresponding period of the previous year. The Group made an provision for finished goods amounting to RMB 33.4 million during the reporting period.

The Group's selling and administrative expenses in the first half of 2006 amounted to RMB281.0 million, an increase of 42.71% as compared with RMB196.9 million in the corresponding period of the previous year, which was mainly due to the sales commission paid during the reporting period.

The Group's other operating expenses in the first half of 2006 amounted to RMB62.1 million, a decrease of RMB71.9 million as compared to the corresponding period of the previous year, primarily due to a decrease in employee reduction expenses during the reporting period.

The Group's financial costs in the first half of 2006 amounted to RMB107.3 million, a decrease of 5.35% as compared to the corresponding period of the previous year, which was primarily due to foreign exchange gains generated from the translation of the US-denominated loans following the appreciation of Reminbi.

The Group's profit after taxation and minority interests significantly decreased by 99.68% from RMB1,763.4 million in the first half of 2005 to RMB5.7 million in the first half of 2006.

Liquidity and capital resources

Net cash inflow provided from operating activities amounted to RMB377.0 million in the first half of 2006, a decrease of RMB1,251.1 million as compared to the corresponding period of the previous year. Due to a substantial decrease in profit before taxation, profit before taxation net of depreciation has brought an operating cash inflow of RMB962.7 million, a decrease of RMB2,051.8 million cash inflow as compared to the corresponding period of the previous year. Increased inventories led to an increase in operating cash outflow of RMB714.5 million at the end of the reporting period (as compared with an increase in operating cash outflow of RMB715.0 million in the corresponding period of the previous year). Changes in trade creditors, other creditors and bills payable led to an increase in operating cash inflow by RMB810.4 million at the end of the period (as compared with a decrease in operating cash inflow of RMB190.5 million in the corresponding period of the previous year). Increases in debtors, bills receivable and deposits led to a decrease in operating cash inflow of RMB304.2 million (as compared with an increase in operating cash inflow of RMB75.2 million in the corresponding period of the previous year due to a decrease in such balances at the end of the period). In addition, as a result of the changes in the accounts balances at the end of the period of the parent company, the subsidiaries and the associates, the Group's cash inflow decreased by RMB39.9 million (as compared with an increase in operating cash outflow of RMB178.9 million in the corresponding period of the previous year).

Borrowings and debts

The Group's long-term borrowings were mainly applied to capital expansion projects. In general, the Group arranges long-term borrowings according to capital expenditure plans, and in overall, there were no seasonal borrowings. Short-term debts were used to meet the Group's needs for working capital during the normal production and operation process. The Group's borrowings at the end of the first half of 2006 amounted to RMB5,387.9 million, a decrease of RMB16.1 million as compared to the beginning of the period, of which, short-term debts decreased by RMB194.0 million and long-term borrowings increased by RMB177.9 million.

The Group issued 270-day short-term commercial papers (or corporate bonds as disclosed in the notes to the unaudited interim financial report) of face value at RMB 1 billion to corporate investors in the PRC interbank debenture market on 24 February 2006. The commercial papers were sold at a discounted value of RMB97.78 per RMB100 par value, with an effective yield of 3.069% per annum, and will mature in November 2006.

As at 30 June 2006, guarantees provided by the Group to the Company's subordinate joint ventures and associates in favor of various banks, and the contingent liabilities to be undertaken on the guarantees provided by the joint ventures to various third parties amounted to RMB64.7 million.

Foreign exchange risks

Since the Group purchases its major raw materials, particularly crude oil from overseas sources through Sinopec Corp., and also exports a portion of the Company's petroleum products directly through Sinopec Corp., a change in exchange rates will indirectly affect the prices of the Group's raw materials and petroleum products which may have a discernible impact on the Group's profitability. In addition, as discussed above, since a small part of the Group's debts is denominated in foreign currencies, a change in the relevant exchange rates will affect the level of the Group's financial expenses which will also have an impact on the Group's profitability.

Capital Expenditure

In the first half of 2006, the Group continued to work diligently on the construction of its major projects. The construction of a 3,300,000-ton/year diesel hydrogenation project and a 380,000-ton/year ethylene glycol project proceeded smoothly, with the former scheduled for substantial completion by the fourth quarter of this year and the latter scheduled for substantial completion by the first quarter of next year. Meanwhile, the Group is actively rolling out the preparatory work for the next round of new development projects such as a flue-gas desulfurization project, a 620-ton/hour steam boiler, a 100-megawatt power generating unit, a 1,200,000-ton/year delayed coking facility and the 600,000-ton/year PX aromatics complex. Construction of these projects is expected to commence within the year.

In the first half of 2006, the Group's capital expenditures amounted to RMB1,080.8 million, comprising capital injections into the 3,300,000-ton/year diesel hydrogenation project and the 380,000-ton/year ethylene glycol project under construction as well as capital injections into other technical renovation projects. In the second half of the year, the Group also plans to proceed with capital injections into a portion of various new projects, while continuing its efforts to advance the construction of the above-mentioned projects. The Group plans to fund the capital expenditures from operating cash income and credit facilities from various banks.

Debt-equity ratio

As at 30 June 2006, the Group's debt-equity ratio was 22.63% compared to 23.22% as at 30 June 2005. The ratio is computed by (total loans and debts) /(total loans and debts + total equity).

Employees

As at 30 June 2006, the number of the Group's employees was approximately 24,327. Our staff costs for the period ended 30 June 2006 totaled RMB593.0 million.

Disclosure required by Listing Rules

Save as disclosed herein, pursuant to paragraph 40 in Appendix 16 of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited ("Listing Rules"), the Company confirmed that there have been no material changes in the existing information of the Company relating to the matters as set out in paragraph 32 in Appendix 16 and the information disclosed in the Company's 2005 annual report.

Market outlook and business plans for the second half of the year

In the second half of 2006, both the global economy and China's economy are expected to maintain steady growth, but the growth may slow. The global supply and demand of crude oil will remain seriously unbalanced. It is anticipated that crude oil prices will continue to remain high and even to peak at new highs as a result of insufficient crude oil production capacity and rising demand for refinery products due to tightening refining capacity, coupled with geo-political risks such as the nuclear issue in Iran and the armed conflicts between Israel and Lebanon as well as other factors such as hurricane attacks, devaluation of the US currency and trading activities by speculative funds. Affected by the above factors, the domestic petrochemical industry will further slowdown in the overall prosperity cycle. Despite a rapid increase in the output of petrochemical products following the successive commencement of production of projects with new and expanded capacity, the growth in demand will slow and the prices of certain products may fall as the government's macro-economic control measures are expected to be stepped up in the second half of the year. Furthermore, rising prices of energy, raw materials and transportation will cause the production costs of petrochemical enterprises to increase more substantially than 2005, so much so that production and operations will not look optimistic. Given the above, in the second half of 2006, the Group will adjust its development approach in line with such economic changes; focus on optimization and adjustment; improve upon the management philosophy; strengthen detailed management, improve work procedures; and accelerate the pace of reform programs. In this respect, the Group will focus on the following:

(i) Strengthening the development of rank-and-file units, the fundamental daily operation and the basic skills training; and maintaining safety, stability and long-cycle operation of production facilities.

(ii) Focusing on resource optimization and utilization, introducing various measures to reduce costs and expenses and enhancing the integrated efficiency of production operations.

(iii) Leveraging support from scientific research and advancing the pace of assets structure and product mix adjustments.

(iv) Advancing corporate reform programs in an orderly manner; continuing to carry out reforms for auxiliary businesses, organizational streamlining and professional centralized management; and maintaining corporate harmony and stability.

2. **Scope and performance of the Company's principle business**

(1) **Description of the scope of the Company's principal business**

Scope of the Company's principal business: crude oil processing, oil refining, production of chemical products, synthetic fibres and monomers, resins and plastics and plastic articles, knitting-ware and textile products.

(2) **Summary of segmental results (Prepared under PRC Accounting Rules and Regulations)**

By segment	Income from principal operations (RMB'000)	Cost of sales (RMB'000)	Gross profit margin (%)	Increase/ decrease of income from principal operations compared to the same period last year (%)	Increase/ decrease of cost of sales compared to the same period last year (%)	Increase/ decrease of gross profit margin compared to the same period last year (%)
Synthetic fibres	2,312,743	2,152,743	6.92	-5.58	3.82	Decrease 8.42 percentage points
Resins and plastics	7,606,847	6,684,742	12.12	9.76	28.66	Decrease 12.91 percentage points
Intermediate petrochemicals	3,048,549	2,546,760	16.46	-12.48	8.47	Decrease 16.14 percentage points
Petroleum products	9,074,588	9,667,732	-6.54	8.66	18.25	Decrease 8.65 percentage points
Trading and others	1,380,553	1,283,107	7.06	105.46	125.05	Decrease 8.09 percentage points
Including: connected transactions	9,136,544	9,489,822	-3.87	1.51	17.79	Decrease 14.36 percentage points

Price-setting principles of connected transactions	The directors of the Company (including independent non-executive directors) believe that the connected transactions were conducted on normal commercial terms which were no less favourable than those offered to or by any third party and were conducted in an ordinary course of business. This was confirmed by the independent non-executive directors of the Group.
Description of the necessity and continuity of connected transactions	The purchases by the Company from China Petroleum & Chemical Corporation ("Sinopec Corp.") and its associates of crude oil-related materials and the sales of petroleum products by the Company to them were conducted in accordance with the State's relevant policy and applicable State tariffs or State guidance prices. As long as the State does not revoke its control over purchases of crude oil, sales of petroleum products and pricing thereof, such connected transactions will continue to happen. The Company sells petrochemicals to Sinopec Corp. and its associates, and Sinopec Corp. and its associates act as agents for the sale of petrochemicals in order to reduce the Company's inventories, to expand its trading, distribution and sales networks and to improve the Company's bargaining power with its customers. The Company accepts transportation, design, construction and installation, insurance agency and financial services from China Petrochemical Corporation ("Sinopec") and its associates in order to secure steady and reliable services at reasonable prices.

(3) **Analysis of the geographical segments for the principal operations**

Geographical segments	Turnover (RMB'000)	Increase/ decrease in turnover compared to the same period of last year (%)
Eastern China	21,995,084	10.52
Other regions in the PRC	1,385,602	-28.55
Exports	59,589	29.20

(4) **Reasons for substantial changes in the profitability (gross profit margin) of the principal operations as compared to the corresponding period of the previous year**

The international crude oil prices increased substantially and remained at a high level, the increase of the Company's major product prices was under pressure and the petroleum product prices controlled by the State led to a substantial decrease in profitability of the principal operations as compared to the corresponding period of the previous year.

(5) **Performance of the companies, in which the Company has investment interests (Prepared under PRC Accounting Rules and Regulations)**
(Apply to situation under which investment income represents 10% or more of the net profit)

Name of the company	Scope of business	Net profit (RMB'000)	Investment income contributed by the companies, in which the Company has investment interests (RMB'000)	Percentage of net loss of the Company (%)
Shanghai Secco Petrochemical Company Limited	Production and distribution of petrochemical products	856,224	171,245	621

3. **Investment of the Company**

1. The Company did not raise capital or the previous capital raised has been used during the reporting period.

2. Capital expenditure

Project	Amount RMB million	Progress As at 30 June 2006
380,000-ton/year ethylene glycol facility	1,249	Under construction
3,300,000-ton/year diesel hydrogenation plant	528	Under construction

4. **Warning on and description of any possibility of the accumulated net profit forecast for the period from the beginning of the year to the end of the next reporting period turning into a loss or any material change in relation to such forecast as compared to the same period last year and the reasons thereof**

In view of high international crude oil prices and that adjustments in the prices of petroleum products had not reflected the rising prices of international crude oil, the Board estimated that net profit of the Group for the nine-month period ended 30 September 2006 will drop substantially as compared to the nine-month period ended 30 September 2005.