

# Report of the Directors

The directors (the “Directors”) of the Company are pleased to present their report together with the audited financial statements of the Company for the year ended 31 December 2006.

## PRINCIPAL ACTIVITIES

The principal activity of the Company is investment holding of its subsidiaries (together with the Company collectively referred to as the “Group”). These subsidiaries are principally engaged in the exploration, development, production and sales of crude oil and natural gas and other petroleum products.

## SUMMARY OF FINANCIAL INFORMATION AND OPERATING RESULTS

Please refer to the financial summary on page 2 for a summary of the assets and liabilities of the Group as at 31 December 2006 and the operating results for the year then ended.

## LOANS

Please refer to note 28 to the financial statements on pages 94 to 95 for details of the long-term bank loans of the Group for the year ended 31 December 2006.

## PROPERTY, PLANT AND EQUIPMENT

Please refer to note 18 to the financial statements on pages 88 to 89 for net movements in property, plant and equipment of the Group for the year ended 31 December 2006.

## RESERVES

The distributable reserves of the Company as at 31 December 2006, as calculated under Section 79B of the Companies Ordinance (Cap. 32 of the Laws of Hong Kong), amounted to RMB14,004,428,000.

Please refer to the consolidated statement of changes in equity on pages 60 and note 33 to the financial statements on pages 109 to 110 for movements in the reserves of the Group and the Company, respectively, for the year ended 31 December 2006.

## SUBSIDIARIES AND ASSOCIATED COMPANIES

Particulars of the Company’s subsidiaries and associated companies as at 31 December 2006 are set out in notes 20 and 21 to the financial statements on pages 90 to 92.

## DIVIDENDS

An interim dividend of HK\$0.12 per share was declared on 29 August 2006, and paid to the shareholders of the Company on 29 September 2006.

The Directors recommended a payment of a final dividend of HK\$0.14 per share for the year ended 31 December 2006, payable on 7 June 2007 to all shareholders on the register of members of the Company on 25 May 2007 subject to shareholders’ approval.

## RETIREMENT BENEFITS

Please refer to note 34 to the financial statements on page 111 for details of the retirement benefits of the Group for the year ended 31 December 2006.

## MAJOR SUPPLIERS AND CUSTOMERS

Purchases from the largest supplier of the Group for the year ended 31 December 2006 represented approximately 18% of the Group’s total purchases. The total purchases attributable to the five largest suppliers of the Group accounted for approximately 52% of the total purchases of the Group for the year then ended.

Sales to the largest customer for the year ended 31 December 2006 represented approximately 22% of the Group’s total revenue. The total sales attributable to the five largest customers of the Group accounted for approximately 45% of the total oil and gas sales of the Group for the year ended 31 December 2006.

For the year ended 31 December 2006, except for the continuing connected transactions with its indirect controlling shareholder China National Offshore Oil Corporation (“CNOOC”) and its associates, as disclosed in the section headed “Connected Transactions” below, none of the Directors or their respective associates or any shareholder of the Company (which to the knowledge of the Directors owns more than 5% of the Company’s share capital) had any interests in the five largest suppliers or customers of the Group.

## CONNECTED TRANSACTIONS

The Independent Non-executive Directors have confirmed that the following connected transactions for the year ended 31 December 2006 to which any member of the Group was a party were entered into by the Group:

1. in the ordinary and usual course of its business;
2. either (a) on normal commercial terms, or (b) where there was no available comparison, on terms no less favourable to the Group than those available to or from independent third parties; and
3. in accordance with the relevant agreement governing them on terms that were fair and reasonable so far as the shareholders of the Company were concerned and in the interests of the shareholders of the Company as a whole.

The Independent Non-executive Directors have further confirmed that for the year ended 31 December 2006:

- (i) Provision of exploration, oil and gas development, oil and gas production as well as marketing, management and ancillary services by CNOOC and/or its associates to the Group:
  - (a) The aggregate annual volume of transactions under the provision of exploration and support services to the Group did not exceed RMB2,117 million.
  - (b) The aggregate annual volume of transactions under the provision of oil and gas development and support services to the Group did not exceed RMB7,628 million.
  - (c) The aggregate annual volume of transactions under the provision of oil and gas production and support services to the Group did not exceed RMB3,935 million.
  - (d) The aggregate annual volume of marketing, management and ancillary services to the Group did not exceed RMB478 million.
  - (e) The aggregate annual volume of transactions of FPSO vessel leases did not exceed RMB453 million.
- (ii) The aggregate annual volume of transactions under the Provision of management, technical, facilities and ancillary services, including the supply of materials from the Group to CNOOC and/or its associates did not exceed RMB50 million;
- (iii) Sales of petroleum and natural gas products by the Group to CNOOC and/or its associates:
  - (a) The aggregate annual volume of transactions under the Sales of petroleum and natural gas products did not exceed RMB48,806 million. (the annual cap was revised in August 2006, and was approved by the independent shareholder on 29 September 2006, and is applicable from 1 January 2006 to 31 December 2006.)
  - (b) The aggregate annual volume of the transactions under the long term sales of natural gas and liquefied natural gas did not exceed RMB1,960 million.
- (iv) The maximum outstanding balance of deposits (including interest received in respect of these deposits) placed with CNOOC Finance Corporation Limited did not exceed RMB6,800 million

The auditors of the Group have reviewed the connected transactions referred to above and confirmed to the Directors that:

1. the transactions have received the approval of the Directors;
2. the transactions were in accordance with the pricing policies as stated in the Company's financial statements;
3. the transactions were entered into in accordance with the terms of the agreements governing the transactions; and
4. the amount of the transactions has not exceeded the cap for which waiver was granted.

## Report of the Directors

Please also refer to note 30 to the financial statements on pages 96 to 101 for a summary of the related party transactions which include the Group's connected transactions.

In order to present a more coherent, logical and understandable picture to shareholders, and also to enable the Company to monitor the status of connected transactions following each category more effectively going forward, the Company has adopted a new categorisation for continuing connected transactions. On 8 December 2005, the Company entered into three comprehensive framework agreements with each of CNOOC, China Oilfield Services Limited and Offshore Oil Engineering Co., Ltd respectively for the provision (1) by the Group to CNOOC and/or its associates and (2) by CNOOC and/or its associates to the Group, of a range of products and services which may be required and requested from time to time by either party and/or its associates in respect of the new categories of continuing connected transactions. The term of each of the comprehensive framework agreements is for a period of two years from 1 January 2006. The new categorisation and caps for each category of continuing connected transactions as approved by the independent shareholders of the Company on 31 December 2005 apply to the Company for the period from 1 January 2006 to 31 December 2007. The annual caps of the continuing connected transactions set out below are applicable for the year ending 31 December 2007.

Categories of continuing connected transactions

Annual caps

*Provision of exploration, oil and gas development, oil and gas production as well as marketing, management and ancillary services by CNOOC and/or its associates to the Group*

- |  |   |
|--|---|
| (a) Exploration and support services                   | For the year ending 31 December 2007, RMB2,293 million  |
| (b) Oil and gas field development and support services | For the year ending 31 December 2007, RMB10,458 million |
| (c) Oil and gas field production and support services  | For the year ending 31 December 2007, RMB4,132 million  |

- |  |  |
|--|--|
| (d) Marketing, management and ancillary services | For the year ending 31 December 2007, RMB504 million |
|--|--|

- |                        |  |
|------------------------|--|
| (e) FPSO vessel leases | For the year ending 31 December 2007, RMB463 million |
|------------------------|--|

*Provision of management, technical, facilities and ancillary services, including the supply of materials from the Group to CNOOC and/or its associates*

- |   |  |
|---|--|
| Provision of management, technical, facilities and ancillary services, including the supply of materials to CNOOC and/or its associates | For the year ending 31 December 2007, RMB100 million |
|---|--|

*Sales of petroleum and natural gas products by the Group to CNOOC and/or its associates*

- |   |   |
|---|---|
| (a) Sales of petroleum and natural gas products | For the year ending 31 December 2007, RMB63,251 million |
|---|---|

(The annual cap was revised in August 2006, and was approved by the independent shareholder on 29 September 2006, and is applicable from 1 January 2006 to 31 December 2006.)

- |  |  |
|--|--|
| (b) Long term sales of natural gas and liquefied natural gas | For the year ending 31 December 2007, RMB3,599 million |
|--|--|

*Deposits with CNOOC Finance Corporation Limited*

The maximum daily outstanding balance of deposits (including interest received in respect of these deposits)	By the end of 7 April 2006, RMB6,800 million
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### SHARE CAPITAL

Please refer to note 32 to the financial statements on page 102 for details of movements in the Company's share capital for the year ended 31 December 2006.

## SHARE OPTION SCHEMES

The Company has adopted the following share option schemes for the grant of options to the Company's Directors, senior management and other eligible grantees:

1. Pre-Global Offering Share Option Scheme;
2. 2001 Share Option Scheme;
3. 2002 Share Option Scheme; and
4. 2005 Share Option Scheme.

Under these share option schemes, the Remuneration Committee of the Company's Board of Directors will from time to time propose for the Board's approval for the recipient of and the number of shares underlying each option. The maximum aggregate number of shares (including those that could be substituted for under the Pre-Global Offering Share Option Scheme, the 2001 Share Option Scheme, the 2002 Share Option Scheme and the 2005 Share Option Scheme) which may be granted shall not exceed 10% of the total issued share capital of the Company as at 31 December 2005), being the date on which the shareholders of the Company approved a new share option scheme, excluding shares issued upon exercise of options granted under these schemes from time to time.

Please refer to note 32 to the financial statements on pages 102 to 105 for details regarding each of the share option scheme of the Company and options granted by the Company pursuant to each of the Pre-Global Offering Share Option Scheme, the 2001 Share Option Scheme, the 2002 Share Option Scheme and the 2005 Share Option Scheme.

During the year ended 31 December 2006, 1,150,000 options granted under the share option schemes of the Company had been exercised. Save as those disclosed in note 32 to the financial statements on pages 106 to 109, no right to subscribe for equity or debt securities of the Company has been granted by the Company to, nor have any such rights been exercised by, any other person during the year ended 31 December 2006.

## PURCHASE, SALE OR REDEMPTION OF SHARES

There was no purchase, sale or redemption of the Company's shares by the Company, or any of its subsidiaries during the year ended 31 December 2006.

## PLACING OF EXISTING SHARES AND SUBSCRIPTION OF NEW SHARES

The Company announced on 27 April 2006 that it successfully implemented a top-up placing. Credit Suisse (Hong Kong) Limited, Goldman Sachs (Asia) L.L.C. and J.P. Morgan Securities Ltd. acted as the joint global coordinators and joint bookrunners for the placement.

Pursuant to the placing agreement dated 27 April 2006, CNOOC (BVI) Limited ("CNOOC (BVI)"), the controlling shareholder of the Company, had agreed to place, through the joint bookrunners, 2,500,000,000 ordinary shares in the Company (the "Shares") to independent investors at a price of HK\$6.15 per Share. The placing price represents a discount of approximately 5.38% to the closing price of HK\$6.50 per Share as quoted on the Stock Exchange on 26 April 2006. The placing price, net of placing commission and other costs and expenses, is approximately HK\$6.06 per Share. CNOOC (BVI) and the Company also entered into a subscription agreement on 27 April 2006 to subscribe for 2,272,727,273 new Shares. The top-up placing was completed on 11 May 2006 after CNOOC (BVI) Limited subscribed for the 2,272,727,273 new Shares. The net proceeds from the issue of new shares by the Company was approximately HK\$13.78 billion.

In accordance with applicable laws and regulations of the PRC, CNOOC had an obligation to procure CNOOC (BVI) to sell 227,272,727 Shares as part of the placing. The State-owned Assets Supervision and Administration Council has approved the allocation of such Shares to the National Social Security Fund (NSSF), and pursuant to NSSF's authorization given to the Company, such Shares was sold by CNOOC (BVI) (acting through the Company) on behalf of NSSF.

The Shares were placed with not less than six placees, who are independent of and not connected with the directors, chief executive or substantial shareholders of CNOOC (BVI), each member of the Group or any of their respective associates. The net proceeds from the issue of new shares was used by the Group to finance the continuing capital expenditure requirements in relation to the OML 130 project in offshore Nigeria, as well as general working capital for the Group's operating activities.

## Report of the Directors

### SUBSTANTIAL SHAREHOLDERS' INTERESTS IN SHARE CAPITAL

As at 31 December 2006, the following persons (other than the Directors and chief executives of the Company) had interests in the shares of the Company as recorded in the register required to be kept by the Company under section 336 of the Securities and Futures Ordinance ("SFO"):

	Ordinary Shares		Percentage of Total Issued Shares
	Directly held	Indirectly held	
(i) CNOOC (BVI) Limited ("CNOOC (BVI)")	28,772,727,268	—	66.41%
(ii) Overseas Oil & Gas Corporation, Limited ("OOGC")	5	28,772,727,268	66.41%
(iii) CNOOC	—	28,772,727,273	66.41%

Note: CNOOC (BVI) is a wholly-owned subsidiary of OOGC, which is in turn a wholly-owned subsidiary of CNOOC. Accordingly, CNOOC (BVI)'s interests are recorded as the interests of OOGC and CNOOC.

All the interests stated above represent long positions. Save as disclosed above, as at 31 December 2006, the Company is not aware of any other person having interests or short positions (other than the Directors and chief executives of the Company) in the shares or underlying shares of the Company as recorded in the register required to be kept under section 336 of the SFO.

### DIRECTORS AND SENIOR MANAGEMENT OF THE COMPANY

Please refer to pages 41 to 45 for information concerning the Directors and senior management of the Company.

### DIRECTORS' INTERESTS

Apart from holding personal interests in options to subscribe for shares in the Company granted under the share option schemes of the Company (as set out in note 32 to the financial statements on pages 106 to 108), as at 31 December 2006, none of the Directors and chief executives of the Company had registered an interest or short position in the shares, underlying shares or debentures of the Company or any of its associated corporations (within the meaning of Part XV of the SFO), or as being recorded pursuant to section 352 of the SFO, or as otherwise notified to the Company and the HKSE pursuant to the Model Code. All the interests held by the Company's directors and chief executive represent long positions.

### DIRECTORS' SERVICE CONTRACTS AND INTERESTS IN CONTRACTS

No re-electing Director has an unexpired service contract with the Company which is not determinable by the Company within one year without payment of compensation (other than normal statutory obligations).

Save as disclosed in this annual report, as at 31 December 2006 or during the year, none of the Directors had a material interest, whether directly or indirectly, in any contract of significance to the business of the Group to which the Company or any of its subsidiaries was a party.

### EMOLUMENTS OF THE DIRECTORS AND THE FIVE HIGHEST PAID INDIVIDUALS

Please refer to notes 12 and 13 to the financial statements on pages 82 to 84 for details of the emoluments of the Directors and the five highest paid individuals of the Company.

### MATERIAL LEGAL PROCEEDINGS

As at 31 December 2006, the Company was not involved in any material litigation or arbitration and no material litigation or claims were pending or threatened or made against the Company so far as the Company is aware.

## COMPLIANCE WITH THE CODE ON CORPORATE GOVERNANCE PRACTICES

The Company is committed to high standards of corporate governance through the establishment of an efficient framework of policies, procedures and systems. Except for deviations from the code provisions A.2.1 and A.4.1, the Company has complied with the code provisions of the Code on Corporate Governance Practices as set out in Appendix 14 of the Listing Rules throughout the year ended 31 December 2006.

Please refer to the Corporate Governance Report on pages 28 to 39 for details.

## AUDITORS

Ernst & Young was appointed as the auditors of the Company for the year ended 31 December 2006 and has audited the accompanying financial statements. A resolution to re-appoint Ernst & Young as auditors of the Company will be proposed at the forthcoming Annual General Meeting to be held on 25 May 2007.

## SUFFICIENCY OF PUBLIC FLOAT

As at the date of this report, the Directors confirmed that based on information that is publicly available to the Company and within the knowledge of the Directors, the Company had maintained sufficient amount of public float as required under the Listing Rules.

## PROCEDURES FOR DEMANDING A POLL

Pursuant to Article 69(a) of the Articles of Association of the Company, a resolution put to the vote of a general meeting shall be decided on a show of hands unless (before or on the declaration of the result of the show of hands or on the withdrawal of any other demand for a poll) a poll is demanded by:

- (i) the Chairman of such meeting; or
- (ii) at least three members present in person (or in the case of a member being a corporation, by its duly authorised representative) or by proxy and entitled to vote at the meeting; or

- (iii) any member or members present in person (or in the case of a member being a corporation, by its duly authorised representative) or by proxy and representing the aggregate not less than one-tenth of the total voting rights of all members having the right to attend and vote at the meeting; or
- (iv) any member or members present in person (or in the case of a member being a corporation, by its duly authorised representative) or by proxy and holding shares conferring a right to attend and vote at the meeting on which there have been paid up sums in the aggregate equal to not less than one-tenth of the total sum paid up on all shares conferring that right.

By Order of the Board

**Fu Chengyu**

*Chairman*

Hong Kong, 29 March 2007