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BUSINESS REVIEW AND PROSPECTS

In 2006, the Company maintained its development in high speed with high efficiency. Each of its operation grew steadily, while the production and net profit both reached a record high.

For the year ended 31 December 2006, our total revenue amounted to RMB88,947.3 million (US$11,143.5 million), representing a 28.1% increase over last year. Net profit of the Group was RMB 30,926.9 million (US$3,874.6 million), representing an increase of 22.1% over last year. The increase was primarily due to our increased production and the higher price of oil. With the rising oil price, we focused our effort on production, tapping the production potential, enhancing the production of current oil fields and at the same time overcame various adverse factors like typhoons. Generally, our production satisfied our objective stated in the beginning of the year.

As at 31 December 2006, the Group's basic and diluted earnings per share were both RMB0.73.

Currently, international oil price has substantially dropped from its highest point last year; however, it is still at a relatively high level at around US$60. According to the forecast of certain institutions such as the World Bank, the global economic growth will slow down, but will grow steadily in general. The PRC government expects to have an 8% economic growth, and the growth rate has been shown as a slowdown. Overall, the global and PRC economies will still have a steady growth. It is anticipated that the international oil price will remain at a relatively high level.

As such, we will increase the capital expenditure on exploration and development, of which we will have a moderate increase in investments of exploration on top of a significant growth in previous year, in order to step-up our efforts in exploration. As some of our projects are under construction, in particular with major projects such as PL 19-3 Phase II and OML130 which will commence production in the next few years, the development capital expenditure will continue to increase.

CONSOLIDATED NET PROFIT

Our consolidated net profit was RMB30,926.9 million (US$3,874.6 million) in 2006, representing an increase of RMB5,603.8 million (US$786.3 million), or 22.1% from RMB25,323.1 million in 2005.

REVENUE

Income from our oil and gas sales for 2006 was RMB67,828.0 million (US$8,497.6 million), representing an increase of RMB14,410.3 million (US$1,983.1 million), or 27.0% from RMB 53,417.7 million in 2005. The increase was attributable to the high oil price, whilst growth in production also attributed to higher profits for the Group. The average realised price for our crude oil was US$58.90 per barrel in 2006, representing an increase of US$11.59 per barrel, or 24.5% from US$47.31 per barrel in 2005. Sale of crude oil amounted to 135.4 million barrels, representing an increase of 4.3% over 2005. The average realised price for our natural gas was US$3.05 per thousand cubic feet in 2006, representing an increase of US$0.23 per thousand cubic feet, or 8.2% from US$2.82 per thousand cubic feet in 2005. At the same time, sales volume of our natural gas increased by 27.8%, from 23.4 million BOE in 2005 to 29.9 million BOE in 2006.

In 2006, our net marketing profit, which was derived from marketing revenue less purchase cost of crude oil and oil products, was RMB391.2 million (US$49.0 million), representing an increase of RMB193.9 million (US$25.0 million), or 98.3%, from RMB197.2 million in 2005. Marketing revenue from the Company's wholly-owned subsidiary, CNOOC China Limited, was RMB15,867.6 million (US$1,987.9 million), representing an increase of RMB6,436.8 million (US$837.8 million) from RMB 9,430.8 million in 2005. The net marketing profit was RMB203.4 million (US$25.5 million), increased 139.3% from last year due to the significantly increase in sales volume in the local market. Marketing revenue from the Company's wholly-owned subsidiary, China Offshore Oil (Singapore) International Pte Ltd., was RMB5,096.5 million (US$638.5 million). Netting off purchase cost of crude oil and oil production, the net marketing profit was RMB187.8 million (US$23.5 million), or 67.3% increased from last year.

Our other income, reported on a net basis, was derived from our other income less corresponding costs. In 2006, our other net income was RMB37.9 million (US$4.8 million), representing a decrease of RMB21.8 million (US$2.5 million) from RMB59.7 million in 2005. The decrease was mainly due to higher service fee charges relating to PSC projects.

EXPENSES

Operating expenses

Our operating expenses in 2006 were RMB6,999.2 million (US$876.9 million), representing an increase of RMB1,064.6 million (US$153.1 million), or 17.9% from RMB 5,934.6 million in 2005. The increase was mainly attributable to the commencement of production of new oil and gas fields in the year. Operating expenses in 2006 were RMB42.3 (US$5.30) per BOE, representing an increase of 9.1% from RMB38.8 (US$4.73) per BOE in 2005. Operating expenses offshore China in 2006 were RMB34.6 (US$4.34) per BOE, representing an increase of 6.6% from 2005. Operating expenses offshore Indonesia in 2006 were RMB119.3 (US$14.94) per BOE, representing an increase of 19.1% from 2005. Besides the increase of service fees, supply vessels, equipment lease, chemicals and fuel, resulting from the higher international crude oil price, the maintenance and repairing cost increased due to the effect of typhoon.

Production taxes

Our production taxes for 2006 were RMB3,315.7 million (US$415.4 million), representing an increase of RMB719.2 million (US$98.7 million), or 27.7% from RMB2,596.5 million in 2005. The increase was mainly due to the increased income from oil and gas sales.

Exploration costs

Our exploration costs for 2006 were RMB1,705.1 million (US$213.6 million), representing an increase of RMB411.4 million (US$55.8 million), or 31.8% from RMB1,293.7 million in 2005, as a result of increased exploration activities.

Depreciation, depletion and amortisation

Our depreciation, depletion and amortisation were RMB6,933.2 million (US$868.6 million) for 2006, repesenting an increase of RMB968.5 million (US$141.2 million), or 16.2% from RMB 5,964.7 million in 2005. Our average depreciation, depletion and amortisation per barrel were RMB41.9 (US$5.25) per BOE, representing an increase of 7.4% from 2005. The increase was mainly attributable to the commencement of production of new oil and gas fields during the year.

Dismantlement

Our dismantling costs for 2006 were RMB472.3 million (US$59.2 million), representing an increase of RMB219.4 million (US$28.4 million) from RMB252.9 million in 2005. The increase was primarily due to the increased dismantling costs resulting from the reevaluation of workload and the higher service fees resulting from the higher international crude oil price. Our average dismantling costs were RMB2.9 (US$0.36) per BOE, which increased from RMB1.7 (US$0.20) per BOE in 2005.

Impairment losses related to property, plant and equipment

Due to the downward revision of the reserve of HZ19-1/2/3 oil fields and the postponement of PY 30-1 gas project, we recognised RMB252.4 million (US$31.6 million) of impairment losses in 2006.

Selling and administrative expenses

Our selling and administrative expenses for 2006 were RMB1,543.8 million (US$193.4 million), representing an increase of RMB173.4 million (US$26.3 million), or 12.7% from RMB1,370.4 million in 2005. Of which, the selling and administrative expenses of companies in China were RMB7.0 (US$0.88) per BOE, representing an increase of 11.8% from 2005. Compared with last year, the increase was mainly attributable to the staff and workers bonus and welfare fund accrued and expense for newly granted share options recognised in 2006.

Finance costs, net of interest income

Our net finance costs for 2006 were RMB1,050.6 million (US$131.6 million), representing an increase of 41.7% from the net finance costs of RMB741.2 million in 2005. On one hand, our interest income increased RMB422.2 million from RMB359.3 million in 2005 to RMB781.5 million in 2006. On the other hand, the finance costs increased significantly due to the losses on fair value changes of the embedded derivative component of the convertible bonds and the effect of increased amount of provision of dismantlement arising from the passage of time. The increases due to the factors mentioned above were RMB1,150.2 million (US$145.3 million), and RMB52.0 million (US$7.2 million) respectively.

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Exchange gains/losses, net

Our net exchange gains incurred in 2006 were RMB308.4 million (US$38.6 million), representing an increase of RMB21.4 million (US$3.6 million) from net exchange gains of RMB287.0 million in 2005. Compared with 2005, the increased exchange gains mainly came from the Chinese government's efforts on the improvement of rate-forming mechanism and the ongoing appreciation of RMB in 2006.

Investment income

Our investment income for 2006 was RMB613.0 million (US$76.8 million), representing a significant increase of RMB365.1 million (US$46.6 million), or 147.3% from RMB247.9 million in 2005. For the purpose of improving performance of current assets portfolio, we increased the investment in financial instruments such as money market funds and the shares of well-known public listed companies. Benefiting from the structural changes in the investment portfolio and the influence from the market, we obtained a favorable return this year.

Share of profits of associates

In 2006, there were gains from our investments in Shanghai Petroleum and Natural Gas Company Limited and CNOOC Finance Corporation Limited. Of them, share of profit from Shanghai Petroleum and Natural Gas Company Limited was RMB246.6 million (US$30.9 million), similar to that of 2005. Share of profit from CNOOC Finance Corporation Limited was RMB75.1 million (US$9.4 million) during the year, representing a significant increase of 65.8% from 2005.

Non-operating income/expenses, net

Our net non-operating income for 2006 was RMB876.4 million (US$109.8 million), and our net non-operating income for 2005 was RMB 28.6 million. The non-operating income in 2006 was mainly contributed by the tax refund from re-investment in China.

Income tax

Our income tax for the year 2006 was RMB13,196.3 million (US$1,653.3 million), representing an increase of RMB2,218.5 million (US$314.5 million), or 20.2% from RMB10,977.8 million in 2005. The primary reason for the increase was the increase in profit before tax. The effective tax rate for 2006 was 29.9%, slightly lower than the effective rate of 30.2% in 2005.

Cash generated from operating activities

Net cash generated from operating activities in 2006 amounted to RMB39,225.6 million (US$4,914.3 million), representing an increase of RMB7,071.8 million (US$993.0 million), or 22.0% from RMB32,153.8 million in 2005.

The increase in cash was mainly due to an increase in profit before tax of RMB7,822.3 million (US$1,100.8 million), an increase in non-cash items such as depreciation, depletion and amortization expenses of RMB968.5 million (US$141.2 million), an increase in finance costs of RMB1,001.3 million (US$128.0 million), an increase in provision for dismantlement of RMB219.4 million (US$28.3 million) and an increase in impairment losses related to property, plant and equipment of RMB162.2 million (US$20.6 million).

Increase of cash flow was also partially offset by an increase of income tax paid of RMB3,025.1 million (US$411.8 million), an increase in short term investment income to be received of RMB146.8 million (US$19.1 million) and a decrease in the loss on disposal and write off of property, plant and equipment of RMB141.2 million (US$17.2 million).

On the other hand, compared with 2005, the increase in operating cash flow was partially attributable to the increase in changes of working capital, mainly due to the increase in changes of current assets from operating activities excluding cash and bank balances of RMB146.8 million (US$26.3 million), and a simultaneous decrease in changes of current liabilities from operating activities of RMB440.0 million (US$59.5 million).

Capital expenditures and investments

Net cash outflow from investing activities in 2006 was RMB39,525.6 million (US$4,951.8 million), representing an increase of RMB10,176.4 million (US$1,372.5 million) from RMB29,349.2 million in 2005.

In line with our use of "successful efforts" method of accounting, total capital expenditures and investments primarily include successful exploration and development expenditures and purchases of oil and gas properties. Total capital expenditures were RMB44,216.6 million (US$5,539.5 million) in 2006, representing an increase of RMB26,747.1 million (US$3,409.0 million), or 153.1%, from RMB17,469.5 million in 2005. Capital expenditures in 2006 mainly comprised of RMB23,041.1 million (US$2,886.6 million) for exploration and development activities, and RMB21,175.5 million (US$2,652.9 million) for acquisition of working interests of OML130 and OPL229. Our development expenditures in 2006 related principally to the development of PanYu 30-1, Bozhong 25-1/25-1S, PL19-3 phase II, NanPu 35-2 oil and gas fields.

In addition, cash inflow was attributable to the decrease in time deposits with maturities over three months of RMB2,967.2 million (US$371.7 million), and the net cash inflow for the available-for-sale financial assets of RMB1,722.2 million (US$215.8 million).

Financing activities

The net cash flow arising from financing activities in 2006 was an inflow of RMB6,038.7 million (US$756.5 million), while in 2005 was an outflow of RMB7,786.4 million (US$949.6 million). Compared with 2005, the cash inflow was mainly contributed by bank loans borrowed and proceeds from the issue of new shares, which were RMB2,413.8 million (US$302.4 million), and RMB14,242.8 million (US$1,784.4 million) respectively during the year. The distribution of dividends of RMB9,813.7 million (US$1,229.5 million), and the repayment of bank loans of RMB807.9 million (US$101.2 million) by the Group generated a total cash outflow of RMB 10,621.5 million (US$1,330.7 million).

Repayment arrangements of our total debts as at 31 December 2006 were as follows:

	Debt maturities principal only Original currency				
Due by 31 December	US$	JPY	RMB	Total RMB equivalent	Total US$ equivalent
			(in millions, except percentages)		
2007	—	271.5	—	17.8	2.3
2008-2010	1,016.6	—	—	7,938.6	1,016.6
2011-2012	551.0	—	500.0	4,802.6	615.0
2013 and beyond	678.7	—	—	5,300.0	678.7
Total	2,246.3	271.5	500.0	18,059.0	2,312.6
Percentage of total debt	97.1%	0.1%	2.8%	100.0%	100.0%

The gearing ratio of the Company was 15.9%. Gearing ratio is (Total Debt)/(Total Debt + Equity).

Market risks

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

Oil and gas price risk

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

Currency risk

Substantially all of the Group's oil and gas sales are denominated in Renminbi and US dollars. In the past decade, the PRC government's policies of maintaining a stable exchange rate and China's ample foreign reserves have contributed to the stability of the Renminbi. Starting from 21 July 2005, China reformed the exchange rate regime by moving into a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. Renminbi would no longer be pegged to the United States dollar ("US dollars"). From that day to 31 December 2006, Renminbi has appreciated by approximately 5.65% against US dollars.

The appreciation of Renminbi against US dollars may have the following impact on the Group. On one hand, since the benchmark oil and gas prices are usually in US dollars, the Group's oil and gas

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sales may decrease due to the depreciation of US dollars against Renminbi. On the other hand, the depreciation of US dollars against Remminbi will also decrease the Group's costs for imported equipment and materials, most of which are denominated in US dollars. In addition, the debt repayment by the Group will decrease since more than 97% of the Group's debts are also denominated in U.S. dollars.

As of the end of 2006, the balance of the yen-denominated loans was only RMB17.8 million. Since the Group has hedged the yen loans against foreign currency swaps, the Group does not expect any significant exchange risk relating to Japanese yen in the future.

Interest rate risk

As of the end of 2006, the interest rates for 89% of the Group's debts were fixed. The term of the weighted average balance was approximately 7.3 years. The average interest rate payable by the Group is considered to be favourable under the environment of rising interest rate hike.

Significant investments and material acquisitions

(i) On 8 January 2006, CNOOC Limited signed a definitive agreement with South Atlantic Petroleum Limited ("SAPETRO") to acquire a 45% working interest in the offshore Oil Mining License 130 ("OML130") in Nigeria for US$2.268 billion in cash. On 20 April 2006, the Company completed its acquisition at a total consideration of US$2.268 billion plus a working capital adjustment of US$424 million for financial, operating and capital expenditures. OML130 has not started commercial production.

(ii) On 27 January 2006, the Group signed an agreement to acquire a 92.1% equity interest in AERD Projects Nigeria Limited, which holds a 38% working interest in the Offshore Oil Prospecting License 229 ("OPL229") in Nigeria at a consideration of US$60 million. The transaction was completed on 4 December 2006. After the transaction, the Group acquired a 35% working interest in OPL229, which was still in an exploration stage as at 31 December 2006.

EMPLOYEES

We had 2,929 employees as at 31 December 2006.

We have adopted 4 share option schemes for directors, senior management officers and other eligible grantees of the Company since 4 February 2001. The Board has granted options to senior management officers pursuant to each share option scheme.

During the year, as a result of corporate growth and surging production costs, the Company took steps to enhance the planning and budget control of its labor costs by implementing target benchmarks in performance appraisals to guide various business units to cut their labor costs and to increase the accuracy rate of their compensation budgets.

At the same time, in order to maximize our return on human resources, the Company paid particular attention to critical business units and key positions in formulating compensation budgets and resources allocation.

In addition, the Company made adjustments to the compensation and allowance policy for overseas staff based on the inflation rates and exchange rates of their homeland countries/regions.

CHARGES ON ASSETS

CNOOC NWS Private Limited is a wholly owned subsidiary, and together with the other joint venture partners and the operator of the NWS Project, signed a Deed of Cross Charge and an Extended Deed of Cross Charge whereby certain liabilities incurred or to be incurred, if any, by the Company in respect of the NWS Project are secured by its interests in the NWS Project.

CONTINGENT LIABILITIES

The Company and certain of its subsidiaries are the named defendants (the "Defendants") in a case brought by a partner of a joint operating agreement ("JOA") in Indonesia (the "Plaintiff"). The Plaintiff is claiming its right under the JOA to request the Defendants to assign part of their interests acquired in the Tangguh Liquefied Natural Gas Project ("Tangguh LNG Project") based on the costs expended by the Defendants. The case is scheduled to be tried in November 2007. The Tangguh LNG Project is still under development.

As the case is still in a preliminary stage, the management considers that the outcome of any judgment on the lawsuit as quite uncertain and any expenditure from the lawsuit is not estimable. Consequently, no provision has been made for any expenses that might arise from the case.