# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL POSITION AND RESULTS OF OPERATIONS

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The following discussion should be read in conjunction with the consolidated financial statements of the Company and its subsidiaries (the "**Group**") and the notes thereto contained in this annual report.

## Overview

For the twelve months ended December 31, 2006, profit before taxation of the Group was RMB199,173 million, representing an increase of 2.8% compared with the previous year. Net profit was RMB142,224 million, representing an increase of 6.6% compared with the previous year. The performance of the Group has again reached a record high and the overall competitiveness of the Group was further enhanced. The Group achieved fruitful results in oil and gas exploration and the oil and gas output hit another historical high. In relation to the refinery and petrochemical operations, the Group continues to optimise resource allocation and has been able to continue to meet market demands. Natural gas and pipeline operations grew quickly with the construction of major natural gas pipelines. Development of international operations accelerated, paving the way for gradual expansion in the scale of the Group's international operations.

For the twelve months ended December 31, 2006, the basic and diluted earnings per share attributable to equity holders of the Company were RMB0.79 (2005: RMB0.75).

## Comparison between the twelve months ended December 31, 2006 and the twelve months ended December 31, 2005

### Consolidated Operating Results

◆ Turnover

Turnover increased 24.8% from RMB552,229 million for the twelve months ended December 31, 2005 to RMB688,978 million for the twelve months ended December 31, 2006. This was primarily due to the increases in the selling prices and sales volume of major products including crude oil, natural gas and certain refined products.

◆ Operating Expenses

Operating expenses increased 36.4% from RMB360,058 million for the twelve months ended December 31, 2005 to RMB491,002 million for the twelve months ended December 31, 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 taxes, depreciation, depletion and amortisation and the employee compensation costs.

◆ Purchases, Services and Other Expenses

Purchases, services and other expenses increased 35.3% from RMB200,321 million for the twelve months ended December 31, 2005 to RMB271,123 million for the twelve months ended December 31, 2006. This was primarily due to (1) an increase in the purchase prices and purchase volume of crude oil and feedstock oil from external suppliers that resulted in the increase in the purchase costs; (2) an increase in the purchase prices and purchase volume of refined products from external suppliers that resulted in the increase in the purchase costs; and (3) an increase in the lifting costs of oil and gas operations and the processing cost of the Group's refineries that resulted from the increase in prices of raw materials, fuel, energy and other production materials in the PRC as well as an expansion of the production scale of the Group. In addition, the increase in the purchase expenses was also resulted from an increase in the refined product supply operation in 2006.

◆ Employee Compensation Costs

Employee compensation costs rose 32.0% from RMB29,675 million for the twelve months ended December 31, 2005 to RMB39,161 million for the twelve months ended December 31, 2006. This was primarily due to (1) an increase in the employees' salaries as a result of continuous growth in the performance of the Group achieved in the twelve months ended December 31, 2006; (2) an increase in the employees' salaries that resulted from the expansion of the scale of operations and the retail network of the Group; and (3) a sequential increase in the welfare expenses as a result of an increase in the salaries.

◆ Exploration Expenses

Exploration expenses increased 20.9% from RMB15,566 million for the twelve months ended December 31, 2005 to RMB18,822 million for the twelve months ended December 31, 2006. To further boost crude oil and natural gas resources, the Group undertook more exploration activities for crude oil and natural gas in the twelve months ended December 31, 2006. There was also an increase in the expensing of exploratory well costs.

◆ Depreciation, Depletion and Amortisation

Depreciation, depletion and amortisation increased 19.7% from RMB51,305 million for the twelve months ended December 31, 2005 to RMB61,388 million for the twelve months ended December 31, 2006. This was primarily due to an increase in the provision for depreciation, depletion and amortisation that resulted from an increase in the average amount of property, plant and equipment and the average net value of oil and gas properties during 2006.

◆ Selling, General and Administrative Expenses

Selling, general and administrative expenses increased 18.3% from RMB36,538 million for the twelve months ended December 31, 2005 to RMB43,235 million for the twelve months ended December 31, 2006. This was primarily due to an increase in transportation and other related costs that resulted from an increase in freights for railway transportation, rises in marine fuel prices and an increase in the sales volume of refined and petrochemical products of the Group during the twelve months ended December 31, 2006. In addition, there was an increase in research and development expenses resulting from intensified technological development efforts in the current year.

◆ Taxes other than Income Taxes

Taxes other than income taxes increased 139.9% from RMB23,616 million for the twelve months ended December 31, 2005 to RMB56,666 million for the twelve months ended December 31, 2006. The increase was primarily due to (1) the imposition by the PRC government of a special levy on the petroleum exploration enterprises since March 26, 2006 which is payable on the portion of the income realised from the sale of domestic crude oil prices exceeding US$40 per barrel; (2) an increase in consumption tax and surcharges as a result of an increase in the output volume of gasoline and diesel by the Group's refineries and an expansion of the scope of consumption tax in the PRC in 2006; and (3) an increase in resource tax resulting from an increase in resource tax rates by the PRC government in the second half of 2005 and an increase in the Group's production volume of oil and natural gas.

◆ Profit from Operations

As a result of the factors discussed above, profit from operations increased 3.0% from RMB192,171 million for the twelve months ended December 31, 2005 to RMB197,976 million for the twelve months ended December 31, 2006.

◆ Net Exchange Gain

Net exchange gain decreased 15.9% from RMB88 million for the twelve months ended December 31, 2005 to RMB74 million for the twelve months ended December 31, 2006. The decrease in the net exchange gain was primarily due to a combination effect of the appreciation of Renminbi against both the United States Dollar and the Japanese Yen and the depreciation in Renminbi against both the Euro and the Pound Sterling.

◆ Net Interest Expenses

Net interest expenses increased 37.7% from RMB838 million for the twelve months ended December 31, 2005 to RMB1,154 million for the twelve months ended December 31, 2006. This increase reflects an

increase in interest expenses recognised as a result of the accretion expense in relation to asset retirement obligations.

◆ Profit Before Taxation

Profit before taxation rose by 2.8% from RMB193,822 million for the twelve months ended December 31, 2005 to RMB199,173 million for the twelve months ended December 31, 2006.

◆ Taxation

Taxation decreased 8.1% from RMB54,180 million for the twelve months ended December 31, 2005 to RMB49,776 million for the twelve months ended December 31, 2006. The decrease was primarily due to the reversal of temporary differences (in relation to certain crude oil sales that were exempted from tax prior to the establishment of the Company in November 1999) that no longer existed as at December 31, 2006.

◆ Net Profit

As a result of the factors discussed above, net profit increased 6.6% from RMB133,362 million for the twelve months ended December 31, 2005 to RMB142,224 million for the twelve months ended December 31, 2006.

## Segment Information

The Group is engaged in a broad range of petroleum-related activities through its four major business segments: Exploration and Production, Refining and Marketing, Chemicals and Marketing and Natural Gas and Pipeline.

### Exploration and Production

The Exploration and Production segment is engaged in the exploration, development, production and sales of crude oil and natural gas.

◆ Turnover

Turnover increased 24.9% from RMB337,208 million for the twelve months ended December 31, 2005 to RMB421,340 million for the twelve months ended December 31, 2006. The increase was primarily due to an increase in the prices and sales volume of crude oil and natural gas. The average realised crude oil price of the Group in 2006 was US$59.81 per barrel, representing an increase of US$11.44 per barrel or 23.7% from US$48.37 per barrel compared with the previous year.

Intersegment sales revenue increased 25.3% from RMB270,943 million for the twelve months ended December 31, 2005 to RMB339,619 million for the twelve months ended December 31, 2006. The increase was mainly due to an increase in the prices of crude oil and natural gas and an increase in the intersegment sales volume.

◆ Operating Expenses

Operating expenses increased 56.0% from RMB129,128 million for the twelve months ended

December 31, 2005 to RMB201,480 million for the twelve months ended December 31, 2006. The increase was primarily due to increases in taxes other than income taxes, purchase expenses and depreciation, depletion and amoritsation.

◆ Profit from Operations

Profit from operations increased 5.7% from RMB208,080 million for the twelve months ended December 31, 2005 to RMB219,860 million for the twelve months ended December 31, 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 rose 26.8% from RMB428,494 million for the twelve months ended December 31, 2005 to RMB543,299 million for the twelve months ended December 31, 2006. The increase was due to an increase in the selling prices and the sales volume of key products, of which:

Sales revenue from gasoline increased 9.4% from RMB110,438 million for the twelve months ended December 31, 2005 to RMB120,771 million for the twelve months ended December 31, 2006. The average realised selling price of gasoline surged 19.3% from RMB4,221 per ton for the twelve months ended December 31, 2005 to RMB5,034 per ton for the twelve months ended December 31, 2006, resulting in an increase in revenue by RMB19,504 million. The sales volume of gasoline decreased 8.3% from 26.16 million tons for the twelve months ended December 31, 2005 to 23.99 million tons for the twelve months ended December 31, 2006, resulting in a decrease in revenue by RMB9,171 million.

Sales revenue from diesel increased 21.7% from RMB176,999 million for the twelve months ended December 31, 2005 to RMB215,459 million for the twelve months ended December 31, 2006. The average realised selling price of diesel increased 19.1% from RMB3,702 per ton for the twelve months ended December 31, 2005 to RMB4,409 per ton for the twelve months ended December 31, 2006, resulting in an increase in revenue by RMB34,544 million. The sales volume of diesel increased 2.2% from 47.81 million tons for the twelve months ended December 31, 2005 to 48.86 million tons for the twelve months ended December 31, 2006, resulting in an increase in revenue by RMB3,916 million.

Sales revenue from kerosene increased 23.2% from RMB7,480 million for the twelve months ended December 31, 2005 to RMB9,219 million for the twelve months ended December 31, 2006.

Intersegment sales revenue increased 35.7% from RMB33,019 million for the twelve months ended December 31, 2005 to RMB44,806 million for the twelve months ended December 31, 2006. The increase was primarily due to a rise in the selling prices of key refined products and changes in their sales volume.

◆ Operating Expenses

Operating expenses increased 27.7% from RMB448,304 million for the twelve months ended December 31, 2005 to RMB572,463 million for the twelve months ended December 31, 2006. The increase


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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 the selling, general and administrative expenses. In addition, the increase in the operating expenses also resulted from an increase in the level of refined product supply operations in 2006.

◆ Loss from Operations

Loss from operations amounted to RMB29,164 million for the twelve months ended December 31, 2006, compared to loss from operations amounted to RMB19,810 million for the twelve months ended December 31, 2005. The increase in the loss primarily resulted from the domestic prices of refined products in the PRC not being in line with that of the international market. Meanwhile, the purchase cost of crude oil and the processing cost of the Group's refineries increased resulting from the rises in international crude oil prices and other production materials.

### 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 rose 11.9% from RMB73,978 million for the twelve months ended December 31, 2005 to RMB82,791 million for the twelve months ended December 31, 2006. The growth in turnover was primarily due to an increase in the sales volume and selling prices of certain chemical products.

◆ Operating Expenses

Operating expenses increased 9.9% from RMB70,702 million for the twelve months ended December 31, 2005 to RMB77,733 million for the twelve months ended December 31, 2006. The increase was primarily due to an increase in the purchase costs for direct materials.

◆ Profit from Operations

Profit from operations increased 54.4% from RMB3,276 million for the twelve months ended December 31, 2005 to RMB5,058 million for the twelve months ended December 31, 2006.

## Natural Gas and Pipeline

The Natural Gas and Pipeline segment is engaged in the sales of natural gas and the transmission of natural gas, crude oil and refined products.

◆ Turnover

Turnover increased 48.5% from RMB26,214 million for the twelve months ended December 31, 2005 to RMB38,917 million for the twelve months ended December 31, 2006. The increase was primarily due to an increase in the sales volume and selling prices of natural gas, and an increase in the volume of natural gas from pipeline transmission and the average price for pipeline transmission of natural gas.

◆ Operating Expenses

Operating expenses increased 30.0% from RMB23,031 million for the twelve months ended December 31, 2005 to RMB29,931 million for the twelve months ended December 31, 2006. The increase was primarily due to an increase in the purchase costs of natural gas and an increase in depreciation charges.

◆ Profit from Operations

Profit from operations increased 182.3% from RMB3,183 million for the twelve months ended December 31, 2005 to RMB8,986 million for the twelve months ended December 31, 2006.

## LIQUIDITY AND CAPITAL RESOURCES

For the twelve months ended December 31, 2006, the Group's primary sources of funds were cash generated from operating activities, and short-term and long-term borrowings. The Group's funds were primarily used for operating activities, capital expenditures, a major acquisition, repayment of short-term and long-term borrowings and distribution of dividends to equity holders of the Company.

As at December 31, 2006, short-term borrowings made up approximately 5.2% of the Group's capital employed as compared with approximately 4.7% as at December 31, 2005. The Group's ability to obtain adequate financing may be affected by the financial position, the operating results and the conditions of the domestic and foreign capital markets. The Group must seek approvals from the relevant PRC government authorities before raising capital in the domestic and foreign capital markets. In general, the Group must obtain the PRC government's approvals for any project involving significant capital investments in the Refining and Marketing segment, the Chemicals and Marketing segment and the Natural Gas and Pipeline segment.

The Group plans to fund its capital expenditures and related investments principally from cash flows generated from operating activities and short-term and long-term borrowings. For the twelve months ended December 31, 2006, net cash flows generated from operating activities was RMB198,102 million. As at December 31, 2006, the Group had RMB48,559 million in cash and cash equivalents. Cash and cash equivalents were primarily denominated in Renminbi (with Renminbi and United States Dollar accounting for approximately 82.5% and 17.5%, respectively).

The table below sets forth the cash flows of the Group for the twelve months ended December 31, 2006 and 2005, respectively and the amounts of cash and cash equivalents as at the end of each year:

| | Year Ended December 31, | |
|---|---|---|
| | **2006** | **2005** |
| | **RMB million** | **RMB million** |
| Net cash flows from operating activities | 198,102 | 203,885 |
| Net cash flows used for investing activities | (158,451) | (91,576) |
| Net cash flows used for financing activities | (71,739) | (42,634) |
| Currency translation differences | (258) | (458) |
| Cash and cash equivalents as at the end of year | 48,559 | 80,905 |

## Cash Flows from Operating Activities

The net cash flows of the Group generated from operating activities for the twelve months ended December 31, 2006 was RMB198,102 million, representing a decrease of 2.8% compared with RMB203,885 million generated for the twelve months ended December 31, 2005. This decrease was primarily due to the cash flows generated from the increased profits during 2006 being offset by the increased cash outflows resulted from the reduction in working capital related to the operating activities of the Group during 2006 and the increase in the income tax payments.

For the twelve months ended December 31, 2006, the Group had current liabilities in excess of current assets of RMB17,657 million compared with the net current assets of RMB22,057 million for the twelve months ended December 31, 2005. The change was primarily due to the payment of approximately RMB21,376 million for the acquisition of a 67% equity interest in PetroKazakhstan Inc. ("**PKZ**") on December 28, 2006 and an increase in the amounts of dividends paid in the twelve months ended December 31, 2006.

## Cash Flows Used for Financing Activities

The net borrowings of the Group as at December 31, 2006 and December 31, 2005, respectively, are as follows:

| | As at December 31, | |
|---|---|---|
| | **2006** | **2005** |
| | **RMB million** | **RMB million** |
| Short-term borrowings (including current portion of long-term borrowings) | 35,763 | 28,689 |
| Long-term borrowings | 35,634 | 44,570 |
| Total borrowings | 71,397 | 73,259 |
| Less: Cash and cash equivalents | (48,559) | (80,905) |
| Net borrowings | 22,838 | (7,646) |

Maturities of long-term borrowings of the Group are as follows:

| | **Principal as at December 31, 2006** | **Principal as at December 31, 2005** |
|---|---|---|
| | **RMB million** | **RMB million** |
| To be repaid within one year | 20,607 | 15,325 |
| To be repaid within one to two years | 11,797 | 18,373 |
| To be repaid within two to five years | 10,449 | 14,942 |
| To be repaid after five years | 13,388 | 11,255 |
| | 56,241 | 59,895 |

Of the total borrowings of the Group as at December 31, 2006, approximately 29.3% were fixed-rate loans and approximately 70.7% were floating-rate loans. Of the borrowings as at December 31, 2006, approximately 74.0% were denominated in Renminbi, approximately 24.8% were denominated in United States Dollar, approximately 0.6% were denominated in Singapore Dollar, approximately 0.4% were denominated in Euro, approximately 0.1% were denominated in Pound Sterling and approximately 0.1% were denominated in Japanese Yen.

As at December 31, 2006, the amount of borrowings owed by the Group to China Petroleum Finance Company Limited ("**CP Finance**") was RMB27,184 million, the amount of borrowings owed to state-owned banks and other state-owned non-banking financial institutions was RMB32,810 million and the amount of borrowings owed to other related parties was RMB5 million.

As at December 31, 2006, the amounts of short-term and long-term borrowings owed by the Group to CP Finance were RMB320 million and RMB26,864 million, respectively.

The net cash flows used for financing activities of the Group for the twelve months ended December 31, 2006 increased 68.3% compared with that for the twelve months ended December 31, 2005. The increase was primarily due to an increase in dividend payments to shareholders of the Company as compared with last year, and also due to the fact that while the Group raised RMB19,692 million through the new issue of H shares in 2005, there was no similar financing activities in the reporting period.

As at December 31, 2006, borrowings of the Group included secured loans (bank borrowings) totaling RMB359 million (RMB1,108 million as at December 31, 2005). These bank borrowings are secured mostly over certain of the Group's properties and time deposits with maturities over one year.

As at December 31, 2006, the gearing ratio of the Group (gearing ratio = interest-bearing debts/ (interest-bearing debts + total equity)) was 10.4% (11.9% as at December 31, 2005).

## Capital Expenditures

The table below sets out our capital expenditures by business segments for the twelve months ended December 31, 2006, the twelve months ended December 31, 2005 and the estimates for 2007 respectively. For the twelve months ended December 31, 2006, capital expenditures of the Group increased 19.2% to RMB148,746 million from RMB124,801 million for the twelve months ended December 31, 2005. The increase in capital expenditures was primarily due to an increase in expenditures relating to crude oil and natural gas exploration and exploitation, development of major petrochemical projects and implementation of safety and environmental protection in 2006 as well as increases in the prices of steel, fuel oil, water, electricity and other production materials.

| | Year Ended December 31, | | | | Estimates for 2007 | |
|---|---|---|---|---|---|---|
| | 2006 | | 2005 | | | |
| | RMB million | % | RMB million | % | RMB million | % |
| Exploration and Production | 105,192* | 70.72 | 83,214* | 66.68 | 115,200* | 62.04 |
| Refining and Marketing | 19,206 | 12.91 | 16,454 | 13.18 | 28,000 | 15.08 |
| Chemicals and Marketing | 10,681 | 7.18 | 13,569 | 10.87 | 16,000 | 8.62 |
| Natural Gas and Pipeline | 11,309 | 7.60 | 11,137 | 8.92 | 18,000 | 9.69 |
| Other | 2,358 | 1.59 | 427 | 0.35 | 8,500 | 4.57 |
| Total | 148,746 | 100 | 124,801 | 100 | 185,700 | 100 |

* If investments related to geological and geophysical exploration costs were included, the capital expenditures and investments for the Exploration and Production segment for 2005 and 2006, and the estimates for the same in 2007 would be RMB92,233 million, RMB114,520 million and RMB127,200 million, respectively.

◆ Exploration and Production

The majority of the Group's capital expenditures were related to the Exploration and Production segment. For the twelve months ended December 31, 2006, capital expenditures in relation to the Exploration and Production segment amounted to RMB105,192 million, including RMB20,481 million for exploration activities and RMB75,050 million for development activities. For the twelve months ended December 31, 2005, capital expenditures in relation to this segment totaled RMB83,214 million, including RMB16,499 million for exploration activities and RMB59,113 million for development activities. The increase in capital expenditures was primarily due to an increase in expenditures relating to oil and gas exploration and exploitation which reflects the Group's goal to stabilise the production of crude oil in eastern China, rapidly develop its business in western China and accelerate the development of natural gas business. In addition, the Group also increased the capital expenditures in relation to the safety and environmental protection for this segment in 2006.

The Group anticipates that capital expenditures for the Exploration and Production segment for the twelve months ending December 31, 2007 will amount to RMB115,200 million. Approximately RMB20,000 million will be used for oil and gas exploration, and RMB95,200 million will be used for oil and gas exploitation. Exploration and exploitation activities will be mainly carried out in basins including the Erdos, Junggar, Tarim, Songliao, Sichuan, Bohai Bay and Chaidamu basins.

◆ Refining and Marketing

Capital expenditures for the Group's Refining and Marketing segment for the twelve months ended December 31, 2006 amounted to RMB19,206 million, of which RMB4,923 million was used in the expansion of the retail sales network of refined products and storage infrastructure facilities for oil products, and RMB10,923 million was used in the construction and expansion of refining facilities. The total capital expenditures of this segment for the twelve months ended December 31, 2005 were RMB16,454 million. The increase in these capital expenditures was primarily due to the construction and expansion of refining facilities. In addition, the Group also increased the capital expenditures in relation to the safety and environmental protection for this segment in 2006.

The Group anticipates that capital expenditures for the Refining and Marketing segment for the twelve months ending December 31, 2007 will amount to RMB28,000 million, which shall include approximately RMB20,000 million for construction and expansion of refining facilities and approximately RMB8,000 million for investments in the expansion of the sales network for refined products.

◆ Chemicals and Marketing

Capital expenditures for the Chemicals and Marketing segment for the twelve months ended December 31, 2006 and 2005 amounted to RMB10,681 million and RMB13,569 million, respectively. The decrease was primarily due to a decrease in the investments during the year as a result of the completion of the ethylene expansion projects in Jilin Petrochemical and Lanzhou Petrochemical which commenced operations in 2006.

The Group anticipates that capital expenditures for the Chemicals and Marketing segment for the twelve months ending December 31, 2007 will amount to RMB16,000 million, which are expected to be used primarily for the construction of the ethylene facilities in Dushanzi Petrochemical and Fushun Petrochemical.

◆ Natural Gas and Pipeline

Capital expenditures in the Natural Gas and Pipeline segment for the twelve months ended December 31, 2006 amounted to RMB11,309 million. The Group incurred RMB10,216 million of these expenditures on the construction of long distance pipelines, of which RMB6,334 million were incurred on the West-East Gas Pipeline project. For the twelve months ended December 31, 2005, capital expenditures in this segment was RMB11,137 million. The amount of capital expenditures incurred in 2006 was substantially similar to that incurred in 2005.

The Group anticipates that capital expenditures for the Natural Gas and Pipeline segment for the twelve months ending December 31, 2007 will amount to RMB18,000 million, which are expected to be used primarily for increasing transmission capacity by the West-East Gas Pipeline project and for construction of underground natural gas storage facilities and pipelines for crude oil and refined products.

◆ Other

Capital expenditures for Other segment (including research and development activities) for the twelve months ended December 31, 2006 and for the twelve months ended December 31, 2005 were RMB2,358 million and RMB427 million, respectively. The increase in capital expenditure was mainly attributable to the inclusion of capital expenditures for certain research and development activities under the Other segment with effect from January 1, 2006 as opposed to the reporting of such capital expenditures under the Exploration and Production segment, the Refining and Marketing segment, the Chemicals and Marketing segment and the Natural Gas and Pipeline segment in previous years.

The Group anticipates that capital expenditures for Other segment for the twelve months ending December 31, 2007 will amount to approximately RMB8,500 million, which are expected to be used primarily for research and development activities and for construction of ERP and other information systems.

## Material Investment

The Group did not hold any material external investment for the year ended December 31, 2006.

## Material Acquisitions or Disposals

On December 28, 2006, the Group acquired a 67% equity interest in PKZ from CNPC International Limited, a subsidiary of CNPC for a consideration of RMB21,376 million. Pursuant to the shareholders' agreement in relation to the acquisition of PKZ, each shareholder of PKZ has a veto right relating to certain financial and operating decisions, and is therefore considered as having joint control over PKZ. In accordance with the Group's accounting policy, the Group accounts for its investment in PKZ, using the equity method of accounting from December 28, 2006.

## Events after the Balance Sheet Date

On March 16, 2007, the corporate income tax law was passed at the Fifth Session of Tenth National People's Congress of PRC whereby all enterprises with operations in the PRC will be subject to the same statutory income tax rate. The Group will evaluate the impact of the new tax law on the operating results and the financial position of the Group when the new tax law is implemented.

## Foreign Exchange Rate Risk

From July 21, 2005, the PRC government 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 projects. The exchange rates of Renminbi are affected by domestic and international economic developments and political changes, 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 subsidiaries, the fluctuation of the exchange rate of Renminbi may have positive or negative impacts on the results of operations of the Group. An appreciation of Renminbi against United States Dollar may decrease the Group's turnover, but the cost for acquiring imported materials and equipment may be reduced. A devaluation of Renminbi against United States 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 2007 and thereafter.

## Industry Risk

Like other oil and 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 by way of grant of exploration and production licences, the imposition of industry-specific taxes and levies and the implementation of environmental and safety standards etc., is expected to have an impact on the Group's operating activities. 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 the PRC governmental policies on the oil and gas industry may also affect the Group's business operations.

## Employees and Employee Compensation

◆ Number of employees

As at December 31, 2006 and December 31, 2005, the Group had 446,290 and 439,220 employees, respectively (excluding temporary staff). The table below sets out the number of employees by business segment as at December 31, 2006:

| | **Number of Employees** | **Percentage of total (%)** |
|---|---|---|
| Exploration and Production | 247,442 | 55.44 |
| Refining and Marketing | 118,504 | 26.55 |
| Chemicals and Marketing | 61,152 | 13.70 |
| Natural Gas and Pipeline | 15,496 | 3.47 |
| Other* | 3,696 | 0.84 |
| Total | 446,290 | 100 |

* "Other" includes staff of the Company's headquarters, specialised subsidiaries, Exploration & Development Research Institute, Planning & Engineering Institute, Petrochemical Research Institute and other units.

◆ Employee Compensation

The total employee compensation payable by the Group for the twelve months ended December 31, 2006 was RMB26,629 million, being the total salaries of employees during the reporting period. Compensation of employees is determined according to industry practice and 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 best results.

The Company's senior management remuneration system links senior management financial interests (including those of executive directors and supervisors) with the Group's results of operations 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 in their compensation 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:

| | **Basic salary (%)** | **Stock appreciation rights (%)** | **Performance bonus (%)** |
|---|---|---|---|
| Chairman | 30 | 70 | 0 |
| President | 25 | 60 | 15 |
| Vice Presidents | 25 | 60 | 15 |
| Department General Managers | 25 | 50 | 25 |

Details of the Directors' and Supervisors' emoluments for the twelve months ended December 31, 2006 and December 31, 2005 were as follows (for remuneration for each of the Directors and Supervisors

on a named basis, please see the consolidated financial statements of the Group and note 10 thereto):

| | 2006 | 2005 |
|---|---|---|
| | **RMB'000** | **RMB'000** |
| Subsidies for directors and supervisors | 1,473 | 897 |
| Salaries, allowances and other benefits | 3,937 | 4,031 |
| Contribution to retirement benefit scheme | 165 | 57 |
| | 5,575 | 4,985 |

The number of directors and supervisors whose emoluments fall within the following band (including directors and supervisors whose term expired during the year):

| | 2006 | 2005 |
|---|---|---|
| | **Number** | **Number** |
| RMB Nil-RMB1,000,000 | 20 | 25 |

Upon exercise of their stock options, members of the senior management will not receive any shares in the Company, but will, by way of stock appreciation rights, receive 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 operating objectives of the Company. In line with the strategic requirement for "a strong corporation with highly talented personnel", the Company has targeted senior management officers, senior professional and technical staff and highly skilled staff in its training programme with a focus on the training of the "core" and "backbone" personnel and strived to build a proficient operating and management team, a technology innovation team and a skilful operators' team to ensure the supply of talents required for the continuous, stable and co-ordinated rapid development of the Company.

◆ Medical Insurance

Since October 1, 2002, the Company's headquarters and its regional branches based in Beijing have joined the basic medical insurance scheme organised by the Beijing Municipality, making contributions at 9% of the total basic salaries of the employees. Other local subsidiaries and branches of the Group have also participated in their respective local basic medical insurance schemes.

As basic medical insurance is organised by local authorities, the dates of implementation, rates of contribution and reimbursement methods vary with the localities. The rate of contribution is generally set at 6% to 10% of the total basic salaries of the employees.

In accordance with the relevant regulations of the PRC government, the Group has given permission to local subsidiaries and branches which have participated in local basic insurance schemes to establish a supplemental medical insurance scheme from 2002. Contributions to the schemes are set at no more than 4% of the total salaries and will be booked as cost.

## CONTINGENT LIABILITIES

Information on the Group's contingent liabilities as at December 31, 2006 is as follows:

◆ Bank and other guarantees

At December 31, 2006, the Group had contingent liabilities in respect of guarantees made to CP Finance, a subsidiary of CNPC, and a State-controlled bank from which it is anticipated that no material liabilities will arise.

| | December 31, 2006 | December 31, 2005 |
|---|---|---|
| | RMB million | RMB million |
| Guarantee of borrowings of associates from CP Finance | 162 | 187 |
| Guarantee of borrowings of third party from a State-controlled bank | 41 | - |
| | 203 | 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 operations 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, the management of the Group 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, the management of the Group believes that any resulting liabilities will not have a material adverse effect on the financial position of the Group.

◆ Leasing of roads, land 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 the following:

- 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 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 December 31, 2006, CNPC had obtained formal land use right certificates in relation to 27,494 out of the above-mentioned 28,649 parcels of land, 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 the 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 the management's opinion, the outcome of the above events will not have a material adverse effect on the operating results 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 investigation into the accident was completed by the PRC government in December 2006. Based on the results of the investigation, the Company paid a fine of RMB1 million in settlement of all liabilities related to the accident.