BUSINESS OPERATING REVIEW

MARKET REVIEW

◆ Crude Oil Market Review

In 2006, there was a huge oil demand but limited increase in oil supply in the international market. International crude oil prices continued to soar and hit record high in the course of the year as a result of factors such as limitation in the oil refining capacity and instabilities in certain oil producing countries. The annual average prices for WTI, Brent and Minas crude oil were US$66.04, US$65.15 and US$65.24 per barrel, respectively, representing an increase of US$9.45, US$10.62 and US$11.05 per barrel, respectively, over the annual average prices in 2005. Corresponding to the rise in international oil prices, domestic crude oil prices also increased. The average realised price for domestic crude oil in 2006 was higher than that of 2005.

Net domestic crude oil imports continued to increase in 2006 by 16.8% to a net total of 139 million tons compared with the previous year. Domestic crude oil output and the amount of crude oil processed reached 184 million tons and 288 million tons, respectively.

◆ Refined Products Market Review

International oil product prices rocketed and maintained at a high level throughout 2006. Domestic refined product prices, however, are not in line with the prices in the international market. Refineries incurred heavy losses in processing. There was a drastic reduction in resources supplied by local refineries. In 2006, transportation of refined products was affected by tight transportation capacity. Overall, there was a tight supply of refined products, a balance in the demand and supply of gasoline, and a rather tight supply of diesel in 2006, and there was a strong pressure for steady supply in the market. Production resumed in local refineries in the fourth quarter as international oil prices dropped. As a result, local refineries resumed production and the tight supply of resources was slightly alleviated. Nominal consumption increased by 6.1% to 174.40 million tons.

◆ Chemical Products Market Review

The PRC economy maintained steady and moderate growth in 2006 with a growth on the GDP by 10.7%. The growth of the PRC economy has created a constant source of demand for energy. The domestic demand for chemical products remains buoyant. Notwithstanding an increase in the production of petrochemical products in 2006 from CNOOC-Shell petrochemical project that commenced production during the year, Jilin Petrochemical Company commenced production of HDPE, Maoming Petrochemical Company commenced production of polypropylene and Daqing Refinery commenced production of polypropylene, the level of increase of petrochemical products was moderate and limited due to factors such as inspection and maintenance of production facilities and unscheduled shut down of production facilities. The overall market condition favours petrochemical products suppliers. Prices of petrochemical products remained high and certain petrochemical products hit new record highs under surging crude oil prices. At the same time, surging crude oil prices throughout the year has increased the cost of raw materials for petrochemical products. As a result, the cost of production of petrochemical products increased remarkably in 2006.

◆ Natural Gas Market Review

At the end of 2005, the PRC government introduced a new pricing regulation for natural gas and increased the ex-factory price of natural gas. To a certain extent, this measure tempered the runaway increase in the demand for natural gas. In 2006, domestic supply of natural gas failed to meet demand.

BUSINESS REVIEW

For the twelve months ended December 31, 2006, total crude oil and natural gas output of the Group was 1,059.4 million barrels of oil equivalent, including 830.7 million barrels of crude oil and 1,371.9 billion cubic feet of marketable natural gas, representing an average daily output of 2.28 million barrels of crude oil and 3,760 million cubic feet of marketable natural gas. A total of 832.80 million barrels of crude oil and 1,357.0 billion cubic feet of natural gas were sold. The Group sold approximately 83% of the crude oil to its refineries. In 2006, the lifting cost for the oil and gas operations of the Group was US$6.74 per barrel, representing an increase of 27.7% from US$5.28 per barrel in 2005. There were two main reasons for the increase in oil and gas operating costs. Firstly, the Group sped up the utilisation of reserves that were difficult to explore and undertook more risky operations, leveraging on the opportunity presented by high crude oil prices. This had led to an increase in unit lifting cost. Secondly, the expansion of production scale, the increases in the prices of raw material, electricity and employees' salaries led to an increase in operating cost, maintenance cost and staff cost. In addition, fluctuation in exchange rates exerted great impact on the increase of unit lifting cost during 2006.

For the twelve months ended December 31, 2006, the Group's refineries processed 785 million barrels of crude oil, representing an average of 2.15 million barrels per day. Approximately 82% of the crude oil processed in the Group's refineries was supplied by the Exploration and Production segment. The Group produced approximately 68.32 million tons of gasoline, diesel and kerosene and sold approximately 74.90 million tons of these products. The Group actively expanded its sales and distribution networks, in particular the retail sales network, by capitalising on the complementary value-added effect of the integration of refining and marketing. As at December 31, 2006, there were 18,207 units of service stations which were either owned, controlled or franchised by the Group or owned by CNPC but to which the Group provided supervisory support. The cash processing cost of the Group's refineries increased from RMB145 per ton to RMB169 per ton.

For the twelve months ended December 31, 2006, the Group produced 2.068 million tons of ethylene, 3.061 million tons of synthetic resin, 1.232 million tons of synthetic fiber raw materials and polymer, 0.312 million tons of synthetic rubber and 3.576 million tons of urea.

For the twelve months ended December 31, 2006, the Group sold 1,200.5 billion cubic feet of marketable natural gas through the Natural Gas and Pipeline segment. The Group currently owns and operates 20,590 kilometres of regional natural gas pipeline networks, of which 19,662 kilometres are operated by the Natural Gas and Pipeline segment. For the twelve months ended December 31, 2006, the Group owned and operated 9,620 kilometres of crude oil pipeline and 2,413 kilometres of pipeline for refined products.