Chairman's Statement and Management Discussion and Analysis

Real Site Photo

On behalf of the board (the "Board") of directors (the "Directors") of China Oil And Gas Group Limited (the "Company") and its subsidiaries (collectively the "Group"), I would like to present the audited result of the Group for the period of 17 months from 1 August 2005 to 31 December 2006 (the "Period").

It was a revolutionary Period for the Group, since the change of substantial shareholder of the Company in February 2006, the entire management of the Company has been changed, and the new management with ample experiences and business connections in the oil, natural gas, and energy field is committed to lead the Group on the road to success. To signify the Group's focus and commitment on the natural gas and energy related business, the name of the Company has been changed to China Oil And Gas Group Limited in October 2006. The Group has also changed its financial year end date to 31 December to line up with its major natural gas operation in the PRC for better control and smooth management.

Under the new management, with trust and respect, the relationship with our business partners is greatly improved, and the Group is unified with its PRC natural gas operation, where the Group is able to manage and improve its natural gas operation in the PRC and take up new business opportunities.

During the Period, the new management has redefined the Group's business strategy with a clear business direction and plans on the development of its natural gas business, and substantial effort was spent on business restructuring and improvements over the existing natural gas operation. We had rationalized the Group's business and investments to completely focus on the core natural gas business, together with stringent operation and management controls, the result is encouraging, the performance has been largely improved, turning around from long loss-making situation to profitable, and the Group has been revitalized.

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FINANCIAL RESULTS

Owing to the change of the financial year end date, the results for the Period are not directly comparable to those of previous financial years.

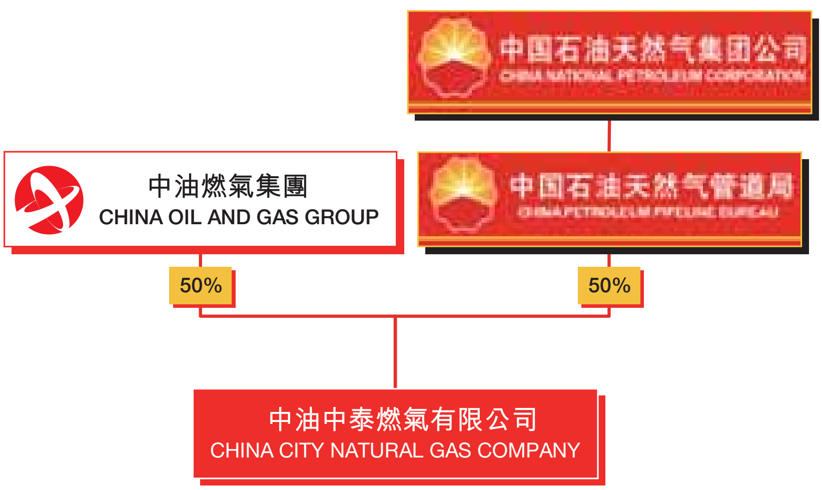
The accounting policy of proportionate equity accounting was adopted for the proportionate consolidation of the Group's interest in China City Natural Gas Co., Ltd, a jointly controlled entity ("JCE") of the Group.

For the Period, turnover of the Group was approximately HK$369.9 million, and turnover of last financial year was approximately HK$200.9 million, by comparing with a year-to-year basis, turnover was increased about 25%, mainly due to the increase in sales of natural gas in the PRC. Overall operating and administrative expenses for the Period were strictly controlled at approximately HK$38.1 million, year-to-year reduced by approximately 26% as compared to approximately HK$37.4 million of last financial year. The Group's profit attributable to shareholders for the Period was approximately HK$57.3 million, where loss of approximately HK$139.8 million was recorded in last financial year. Earnings per share for the Period was approximately HK$0.031 (2005 Loss per share: HK$0.093).

The Board does not recommend any dividend for the Period ended 31 December 2006 (2005: Nil).

BUSINESS REVIEW

The Group is principally engaged in investment in the natural gas and energy related business. The Group, through China City Natural Gas Co., Ltd ("CCNG"), a joint venture company formed with China Petroleum Pipeline Bureau ("CPP") which is a wholly owned subsidiary of China National Petroleum Corporation ("CNPC"), to invest and operate natural gas business in various cities (Xining, Lining, Binzhou, Huimin, and Qingyun) in the PRC.



Incorporated in 2003, CCNG is one of the natural gas companies of earliest presence in the natural gas industry in China. Over years of development, it has been developed as an integrated natural gas company, the business and operation of which include gas pipeline and infrastructure design and construction, technical support, gas selling and distribution, city gas management, vehicle modification for gas application, natural gas stations operations, and production of liquefied natural gas.

CCNG Group has recorded a turnover of approximately HK$739.8 million (proportionate to the Group: approximately HK$369.9 million) for the Period, and approximately HK$401.8 million (proportionate to the Group: approximately HK$200.9 million) for the last financial period. The increase in turnover was mainly due to the increase in sales of natural gas, which was largely contributed by industrial and public utility segments.

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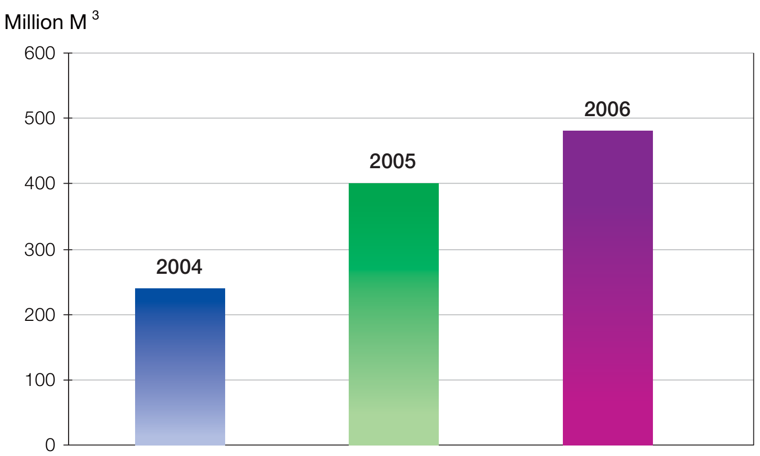
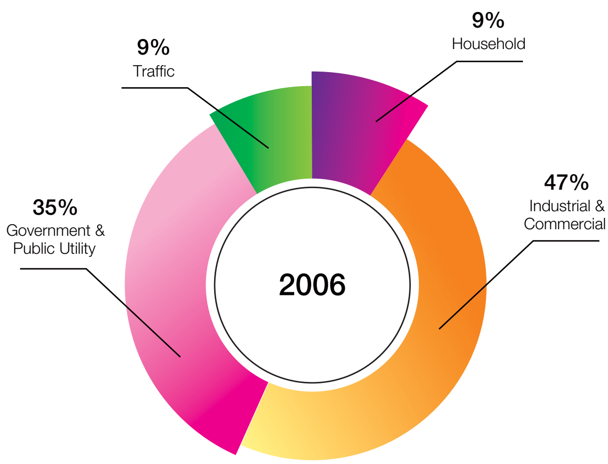
CCNG Group – Change in 2006 on a year-to-year basis

- Total turnover increased by 25%
- Total gas sales volume increased by 20%, reached 480 million M^3
- Total number of connected (supplying gas) users increased by 22%
- Profit after tax increased by 36%

Increase in gas sales volume (million M^3) from year 2004 to 2006



Gas sales volume analysis by user group for year 2006



CCNG is an important and strategic operational arm for the Group. Since the joining of the new management, we have been, under a harmonic and trustful relationship, working closely with our partner – CPP on the development of CCNG. We will continue to develop our existing city gas projects as there is still huge room for growth, and we plan to increase the investment in CCNG for the upcoming new gas projects.

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In addition to the piped city gas business, we decided to expand our business to compressed natural gas ("CNG") refueling stations business. We plan to setup a nationwide CNG stations network to capture the business opportunities in traffic, so that we can broaden our distribution network and customer base. The operation of the CNG stations business is relatively simple and easy to manage with lower safety risk and higher profit margin as the price of CNG is directly compared and competitive to gasoline with almost the same efficiency. Moreover, it is mainly a cash based business which will provide stable income streams to enhance the earning base of the Group.

So far, the Group has acquired three natural gas stations projects, and will setup CNG stations in Qingyun, Binzhou, Nanjing and Maanshan. The main CNG station in Maanshan, Anhui has just come into operation, while the rest are being constructed and scheduled to begin operation within this year.

Business Strategy

From those years' operation and management of natural gas businesses, we have not only gained precious experience, but also developed proven success business model and marketing strategies, and more important we have acquired a large crew of well trained professional people with technical competence and expertise in every aspect in the oil and gas industries.

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In forming our business plans and strategy, CPP had provided valuable advice and insight, and CPP will definitely have large involvement and play an important part in the Group's future development. Our strategy aims for both horizontal and vertical expansion. Horizontally speaking, we will continue to develop the downstream retail market, start up new piped city gas projects, look for more suitable locations for our CNG stations network, and open up to ancillary oil and gas services and businesses, such as transportation and logistics.

To support and sustain the horizontal expansion, we, at the same time, will also actively seek business opportunities in the upstream area for vertical expansion, so as to spread our business risk, enhance our competitiveness, and specifically to strengthen and stabilize the supply of gas sources. Accordingly, we shall be able to achieve better control over market development.

We recognize the importance of growth and expansion, in seeking business or investments opportunities, we believe in professional, knowledge and experience, and we emphasis on quality rather than quantity. We will carefully assess potential projects based on a balanced score approach, evaluating factors like controls and management over the projects, availability and reliability of gas source, economic returns, technical feasibility, long run stability and sustainability, consumer composition, harmonic local relationship, etc.

Prospects

The economy of Mainland China is growing in a steady pace, GDP of which has increased by about 10.7% in 2006, and expected to grow by about 9.8% in 2007. However, the GDP does not reflect the quality of the country's development, and there are increasing concerns on the costs to the environment. Along with the rapid growing economy, the demand for green energy is surging, whereas natural gas, as a clean, efficient, and affordable green fuel, is highly encouraged and widely adopted over the world, consumption of which share about 25% of total world energy consumption, where in China, natural gas only accounts for about 2-3% of total energy consumption. The PRC government is highly encouraging the use of natural gas as a primary energy sources for better environment and improvement over severe air pollution. It is indicated in the country's 11th five years planning that the consumption of natural gas shall be increased to 8% of total energy consumption by the year 2010. With the government support and favorable policies, it would be the trend that natural gas will become a major fuel energy in China. and we are optimistic and see enormous potential in the future of the gas industries.

Under the new management, backed by our business partners, we will adhere to our business strategy to rationally invest and expand our business through new investment projects, merger and acquisitions, and open up to other oil and gas related business with the objective to develop the Group as an integrated leading oil and gas company.

Employees and Remuneration Policy

As at 31 December 2006, The Group employed a total workforce of approximately 340 (2005: 328) among which 9 employees (2005: 8) were stationed in Hong Kong and 331 employees (2004: 312) were stationed in the PRC. The staff costs for the year amounted to approximately HK$9.4 million (2005: 11.4 million). The employees' remuneration, promotion and salary are assessed based on work performance, working experiences and professional qualifications and the prevailing market practice.

Pledge of Assets

As at 31 December 2006, certain pipelines and the operation right of one of our natural gas operation in the PRC were pledged to secure a bank loan of approximately HK$10.1 million (2005: HK$29 million).

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Contingent Liability

As at 31 December 2006, the jointly controlled entity of the Group provided financial guarantees on loan facilities granted to its existing and disposed associates to the extent of approximately HK$70 million (2005: HK$47 million), where the financial guarantee provided in favor of the disposed associate is in the process of relinquishment.

Save for disclosed above, the Group did not have other significant contingent liabilities

Foreign Exchange and Interest Rate Exposure

As the Group's sales are mostly based on Renminbi, and investments are mostly made in Hong Kong Dollar, having considered the exchange rate of the said currency is fairly stable, no foreign exchange and interest rate risk management or related hedges were made, proper policy will be in place when the Board considers appropriate.

Litigation

As at 31 December 2006, the Group has no litigation.

LIQUIDITY AND FINANCIAL RESOURCES

Capital Investment and Commitments

In July 2006, the Group entered into an agreement to acquire 80% of Accelstar Pacific Limited ("Accelstar") at the consideration of HK$58.5 million of which HK$48 million was satisfied by cash, and 175,000,000 shares of the Company has been issued as consideration shares ("Accelstar Acquisition"). Accelstar and its subsidiaries are principally engaged in investments and operation of CNG gas stations business in Qyingyun and Binzhou. The Accelstar Acquisition was completed in November 2006, and the Company shall provide an interest free shareholder's loan of approximately HK$9 million to Accelstar for the construction and operation of the natural gas stations for 2 years.

In December 2006, the Group entered into an agreement to acquire 80% of Plentigreat Holdings Limited ("Plentigreat") at the consideration of HK$133 million of which HK$67 million was satisfied by cash and HK$66 million was satisfied by issue of convertible note of the Company ("Plentigreat Acquisition"). Plentigreat and its subsidiaries are principally engaged in investments and operation of CNG gas stations in Nanjing. The Plentigreat Acquisition was completed in February 2007, and the Company shall provide an interest free shareholder's loan of HK$12 million to Plentigreat for the construction and operation of the natural gas stations for 5 years.

In December 2006, the Group also entered into an agreement to acquire the entire interest of Vast China Group Limited ("Vast China") including the vendor's shareholder's loan in Vast China at the consideration of approximately HK$196.4 million of which HK$10.4 million was satisfied by cash, HK$90 million was satisfied by issue of convertible note of the Company, and 400,000,000 shares of the Company were issued as consideration shares ("Vast China Acquisition"). Vast China and its subsidiaries are principally engaged in investments and operation of CNG gas stations business in Maanshan. The Vast China Acquisition was completed in March 2007, and the Company shall provide an interest free shareholder's loan of HK$12 million to Vast China for the construction and operation of the natural gas stations for 5 years.

Save for the abovementioned acquisitions and the shareholders' loans to be provided by the Company under the acquisitions, the Group did not incur or commit other material investment or capital expenditure.

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Borrowings

As at 31 December 2006, the Group has total borrowings of approximately HK$52.8 million (2005: HK$82.7 million), representing the proportionate borrowing of CCNG, of which approximately HK$10 million representing the secured bank loan with an interest rate of 5.58% repayable within 2 years, and the rest being the project loans for Xining's operation partly with a floating interest rate and partly in a fixed repayment terms. As at 31 December 2006, the Group's gearing ratio, measured on the basis of total liabilities as a percentage of total equity, was 0.48 (2005: 0.7).

Subsequent to the balance sheet date on 1 February 2007, the Company, under the Plentigreat Acquisition, issued convertible note in the principal amount of HK$66 million to New Stamina Investments Limited at a conversion price of HK$0.24 per share convertible into 275,000,000 new shares of HK$0.01 each in the capital of the Company ("NS CN"). The NS CN is interest bearing of 1% per annum with a maturity of 2 years, and is convertible from the date after six calendar months of the issue date and prior to the maturity date.

Subsequent to the balance sheet date on 20 March 2007, the Company, under the Vast China Acquisition, issued convertible note in the principal amount of HK$90 million to Sino Vantage Management Limited at a conversion price of HK$0.24 per share convertible into 375,000,000 new shares of HK$0.01 each in the capital of the Company ("SVM CN"). The SVM CN is non-interest bearing with a term of 2 years, and is convertible from the date after six calendar months of the issue date and prior to the maturity date.

Save for the proportionate borrowings of CCNG and the convertible notes issued subsequent to the balance sheet date, the Group has no other bank loans, overdraft or borrowings.

Capital Structure

During the Period, subscription rights attaching to 70,000,000 option shares were exercised at the subscription price of HK$0.058 per share resulting in an issue of 70,000,000 shares of HK$0.01 each for a total cash consideration of approximately HK$4,060,000.

On 11 September 2006, the Company entered into a placing agreement with Guotai Junan Securities (Hong Kong) Limited for the placing of 540,000,000 new shares at HK$0.12 per share. The placing was completed in October 2006 and a net proceed of approximately HK$64 million was raised.

On 21 December 2006, the Company entered into a placing agreement with SBI E2-Capital Securities Limited for the placing of 360,000,000 new shares at HK$0.29 per share. The Placing was completed subsequent to the balance sheet date in January 2007 and a net proceed of approximately HK$104 million was raised.

The NS CN and SVM CN issued subsequent to the balance sheet date entitle the noteholders to convert up to 650,000,000 new shares of the Company assuming fully exercised.

As at 31 December 2006, the Group had total assets of approximately HK$492.5 million (2005: HK$312.4 million). Current assets were approximately HK$306.2 million (2005: HK$180.9 million), and current liabilities were approximately HK$118.6 million (2005: HK$55 million). The current ratio of the Group is 2.6 (2005: 3.3) and the quick ratio is 2.5 (2005: 3.1).

Xu Tie-liang
Chairman

Hong Kong, 17 April 2007