Management Discussion and Analysis

(Unless otherwise specified, financial information included in the Management Discussion and Analysis has been extracted from financial statements prepared under IFRS.)

A. Operating Results

General - Review of the Company's Operation during the Reporting Period (Business Review)

In 2006, the world's economy maintained relatively fast growth while the overall development of the global petrochemical industry was solid, and was still remaining at a prosperous stage of its growth cycle. Through strengthening and enhancing macro-economic control measures, the economy of China was in a state of relatively fast growth, and has achieved better economic efficiency and lower price levels. Driven by a good macro environment and the prosperous cycle, the petrochemical industry in China was able to maintain a relatively rapid pace of growth as a whole, whilst attaining satisfactory results with gradual and solid increase in the output of major products and sustaining strong growth in economic efficiency. However, there was a relatively severe polarization of operating results across the whole industry. Growth mainly came from the crude oil and natural gas exploration segment, while certain segments such as crude oil processing demonstrated a decline in earnings or even suffered a loss. In 2006, the Group faced adverse operating conditions such as the successive increases in international crude oil prices, which climbed to record highs one time after another and kept hovering at high levels. The Group also suffered severe losses in relation to its oil refining operation as a result of the price controls imposed on petroleum product by the State. In order to tackle these difficult operating conditions, the Group actively carried out cost leadership strategy, lengthened the production cycle, and strengthened the safety and stability of the operation of its production facilities. It also gradually pushed for a more professional and centralized management, reformed its auxiliary businesses and clean-up and shake-up investment at subsidiary level, as well as specifically enhancing internal management. As a result, the Company has been able to maintain a stable production operation in general. Positive progress was reported regarding the reform of auxiliary businesses, clean-up and shake-up investment at subsidiary level, internal management, project construction, technology research and development, staff training and corporate culture cultivation, etc. Nevertheless, the Group's economic efficiency saw a substantial fall over 2005 as a result of the high cost for crude oil, despite the fact that its turnover in 2006 broke the RMB50,000 million threshold and reached a record high of RMB50,599.5 million.

(1) Making new progress in resource optimization and maintaining a stable production in general

In 2006, the Company aggressively strived for the optimization of the utilization of raw materials such as crude oil and ethylene, as well as the optimization of the usage of energy and power. It ensured a safe and stable operation of its production facilities with a long production cycle, and timely adjusted its product structure in accordance with market conditions. In addition, the Company actively increased its products output with a higher cost efficiency, and reduced or even ceased producing certain unprofitable products. During the year, the on-stream availability and the average load factor of the Company's major production facilities were 95.33% and 96.62%, respectively. Operation of major production facilities remained steady, with the number of non-scheduled suspensions decreased by 23.53% as compared to the previous year while the duration of non-scheduled suspensions decreased by 32.40% as compared to the previous year. No major safety-related incidents or environmental pollution incidents took place during the year.

In 2006, the Company processed 8,920,300 tons of crude oil, representing a decrease of 6.03% as compared to the previous year. Production outputs of gasoline, diesel and jet fuel also decreased, in which the Company produced 761,500 tons, 2,742,100 tons and 533,800 tons, respectively. The Company produced 960,300 tons of ethylene and 517,700 tons of propylene, similar to the respective figures for the previous year; 1,087,800 tons of synthetic resins and polymers, representing an increase of 1.94% over the previous year; 549,500 tons of synthetic fibre monomers, representing an increase of 11.29% over the previous year; 604,600 tons of synthetic fibre polymers, representing an increase of 1.47% over the previous year; and 330,000 tons of synthetic fibres, representing a decrease of 7.46% over the previous year. Meanwhile, the quality of the Company's products was consistently maintained at a premium level, and the Company continued to top the nation in production outputs of ethylene and acrylic fibre.

(2) Market demand for petrochemical products remained robust, but product prices witnessed frequent volatility

In 2006, international crude oil prices witnessed fluctuations at high levels. Prices climbed initially but declined later. Domestic demand for petrochemical product remained relatively strong. Prices for a majority of products increased as compared to the previous year, but price fluctuations were frequent. For the year ended 31 December 2006, the weighted average prices (exclusive of tax) of the Company's synthetic fibres, resins and plastics, intermediate petrochemicals and petroleum products increased by 4.26%, 9.02%, 3.47% and 14.11%, respectively, over the previous year.

(3) Impact of crude oil costs

International oil prices continued to surge and become volatile at high levels in 2006 for the third consecutive year, soaring to historic highs in July 2006 (Brent crude oil price recorded a highest closing price of US$78.30 per barrel, while the WTI ("West Texas Intermediate") crude oil price on the New York Stock Exchange recorded a highest closing price of US$77.03 per barrel). The prices started to decline rapidly since August, thereby resulting in an overall trend of price decline after fluctuations at high levels. According to statistics, in 2006 the annual average price of Brent crude oil increased by approximately 20% over the previous year to reach US$65 per barrel. For the year ended 31 December 2006, the Group processed 8,920,300 tons of crude oil (inclusive of oil processed on a sub-contracting basis), representing a decrease of 572,700 tons over the previous year. Of this volume, offshore oil accounted for 348,300 tons and imported oil accounted for 8,572,000 tons. Crude oil processed by the Group on its own totaled 8,810,200 tons, down 4.43% over the previous year. Of the Group's cost of sales, crude oil costs accounted for RMB33,307.6 million or 67.72% of the Group's annual cost of sales. The average cost of crude oil processed was RMB3,780.56 per ton, representing an increase of 17.84% over the previous year. The crude oil costs increased by RMB3,731.2 million as compared to 2005.

(4) Further strengthening operation management, facilitating continued optimization and enhancing production operation approaches

In 2006, the Company further strengthened operation management, elevating the integration of production versus operation and planning versus market needs, thus facilitating continued optimization and enhancement of its production operation approaches. As a result, the output to sales ratio reached 100.33%. Turnover amounted to RMB50,599.5 million, representing an increase of 10.10% over the previous year. Management of sales contracts and receivables were stepped up as well, with a receivable recovery ratio of 100.08% during 2006. Procurement of resources was effectively managed, with procurement costs for general resources below average market prices.

(5) Project construction proceeded smoothly, with full commencement of structural adjustment projects

In 2006, the Company put a lot of effort on the construction of key projects. The 3,300,000 tons per year diesel hydrogenation project was mechanically completed on 6 December, while the 380,000 tons per year ethylene glycol plant was mechanically completed on 24 December. The Group's structural adjustment project, which aimed at further adjusting and optimizing businesses and products, has fully commenced since the end of 2006. Construction work has begun for the project of adding flue gas desulphurization facilities to the furnaces of coal-fired power plants, the 620 tons of steam / hour boiler and the 100MW power generation unit project, the 1,200,000 tons / year delayed coking plant project, and so forth.

The Shanghai Secco 900,000 tons / year ethylene joint venture project between the Company, Sinopec Corp. and BP Chemicals East China Investments Ltd. operated in a normal manner in 2006, whereby 978,000 tons of ethylene were produced during the year, representing an increase of 52.33% over the previous year. The project was top in the nation in terms of ethylene output.

(6) Making progress in development of new technologies and products with reference to the actual corporate production operation needs

In 2006, the Company continued to make progress in the development of new technologies and products with reference to the actual needs of corporate development and production operation. Key development projects such as the development and application of gasoline blending technology, the studies on industrial application of domestically-made bimodal polyethylene catalyst, the industrial studies and application of NaSCN solvent's super-purification for the Jinyang unit, the 150,000 tons/year C5 segregation technique software package, and so forth, reported development breakthroughs. New progress was also seen in the development of new products such as extra-soft acrylic fibres, special high-gloss and heat-resistant polypropylene, special powder coatings, and so forth. According to statistics, the Company's output of new products was 817,000 tons during the year, up 34.48% over the previous year; output value ratio was 19.81%, while output to sales ratio was 96.85%. 243,100 tons of differentiated synthetic fibres were produced, and the ratio of differentiated synthetic fibres was 73.75%, up 18.28 percentage points over the previous year. 831,600 tons of special plastic were produced, and the ratio of special plastic was 83.13%, up 1.95 percentage points over the previous year. Thirty-one patent applications were submitted during the year, all of which were invention patents applied in the PRC in relation to the development of the above-mentioned new technologies and new products.

(7) Further enhancement of corporate management and internal reform, with gradual progress on auxiliary business reform, clean-up and shake-up investment at subsidiary level work and professional centralized management

In 2006, the Company further enhanced its internal control, information management and staff training. The Internal Control Manual of Shanghai Petrochemical (2006 Edition) was adopted on 1 May 2006 upon consideration and approval by the Board. During the year, self-checking and professional checks were conducted over the implementation of all procedures and the effectiveness of control with reference to The Guideline for Internal Control Checking and Assessment, with investigations, analyses and rectifications made for problems identified in business procedure implementation. The Company also engaged KPMG Internal Audit team to perform COSO ("the Committee of Sponsoring Organisation of the Treadway Commission") entity level gap analysis to assist management evaluation of the Company's internal control environment. Through adjustments of the information management system, further application of the ERP ("Enterprise Resource Plan") system and RPMS ("Refining and Processing Integration Plan - Optimized Model System") was facilitated, effectively enhancing the production operation management quality of the Company. By way of integrating training resources, the Company proactively adopted the training approach of centralized management and grade-by-grade implementation, thereby strengthening the effort on educational training and further enhancing the quality of its staff.

In 2006, the Company actively pushed for the implementation of an auxiliary business reform, clean-up and shake-up investment at subsidiary level work and professional centralization of core operations. Among the original livelihood-related logistics services, a large number have basically completed the divestiture reforms and have been separated from the core operations. At the same time, thorough checks have been conducted on external investments and the conditions of various operations, with withdrawals from certain ventures completed after the clean-ups. According to the requirements of flatten management, the Company has effected centralized management of quality assurance analysis, environmental protection analysis (including occupational hygiene checks) and power substation consumption reduction efforts. To effectuate the above noted reforms and centralization of management, by 31 December 2006, the Company reduced its work force by 2,559 employees, which reduction included voluntary resignees and retirees representing 10.04% of the total employees as at the beginning of 2006.

(8) Analysis of the reasons for the significant fall in operating results for the year

The significant fall in the operating results during the Reporting Period was mainly attributable to the following reasons:

a. The Group's production costs rose significantly over the previous year as a result of the continued high international crude oil prices. Given that crude oil costs accounted for up to 67.72% of the Group's annual costs of sales and that the average costs of crude oil processed had increased by 17.84% over the previous year, the increases of average costs of crude oil processed were far more than the corresponding price increases for the Group's four major products. Therefore, the Group's profitability was reduced substantially.

b. In 2006, despite the fact that the State had raised the prices of petroleum products, there was no change in the situation that prices of domestic petroleum products were significantly below international prices, with domestic oil refineries continuing to suffer severe losses. With petroleum products accounting for almost half of the volume of crude oil processed by the Group, despite a subsidy of RMB282.1 million granted to the Group by the Ministry of Finance the Group was still unable to fully make up the gross loss of RMB1,937 million (inclusive of sales tax) arising from the sale of petroleum products, such that total profits of the Group fell remarkably in 2006 over the previous year.

Critical Accounting Policies

The Group's financial condition and results of operations are sensitive to accounting methods, assumptions and estimates that underlie the preparation of its financial statements. The Group bases the assumptions and estimates on historical experience and on various other assumptions that the Group believes to be reasonable and which form the basis for making judgements about matters that are not readily apparent from other sources. On an on-going basis, management evaluates its estimates. Actual results may differ from those estimates as facts, circumstances and conditions change.

The selection of critical accounting policies, the judgements and other uncertainties affecting application of those policies and the sensitivity of reported results to changes in conditions and assumptions are factors to be considered when reviewing the financial statements. The Group believes the following critical accounting policies involve the most significant judgements and estimates used in the preparation of the financial statements.

Impairments for long lived assets

If circumstances indicate that the net book value of a long-lived asset may not be recoverable, the asset may be considered "impaired", and an impairment loss may be recognised in accordance with IAS 36 "Impairment of Assets". The carrying amounts of long-lived assets are reviewed periodically in order to assess whether the recoverable amounts have declined below the carrying amounts. These assets are tested for impairment whenever events or changes in circumstances indicate that their recorded carrying amounts may not be recoverable. When such a decline has occurred, the carrying amount is reduced to recoverable amount. For goodwill, the recoverable amount is estimated annually. The recoverable amount is the greater of the net selling price and the value in use. It is difficult to precisely estimate selling price because quoted market prices for the Group's assets are not readily available. In determining the value in use, expected cash flows generated by the assets are discounted to their present value, which requires significant judgement relating to level of sale volume, selling price and amount of operating costs. The Group uses all readily available information in determining an amount that is a reasonable approximation of recoverable amount, including estimates based on reasonable and supportable assumptions and projections of sale volume, selling price and amount of operating costs.

Depreciation

Property, plant and equipment are depreciated on a straight-line basis over the estimated useful lives of the assets, after taking into account the estimated residual values. The Group reviews the estimated useful lives of the assets regularly in order to determine the amount of depreciation expense to be recorded during any reporting period. The useful lives are based on the Group's historical experience with similar assets and taking into account anticipated technological changes. The depreciation expense for future periods is adjusted if there are significant changes from previous estimates.

Impairment for bad and doubtful debts

The Group estimates impairment losses for bad and doubtful debts resulting from the inability of the customers to make the required payments. The Group bases the estimates on the aging of the accounts receivable balance, customer credit-worthiness, and historical write-off experience. If the financial condition of the customers were to deteriorate, actual write-offs would be higher than estimated.

Summary

The following table sets forth the Group's sales volumes and net sales (net of sales taxes) for the years indicated (prepared under IFRS):

For the Years ended 31 December

	2006			2005			2004		
	Sales Volume ('000 tons)	**Net Sales (Millions of RMB)**	**% of Total**	Sales Volume ('000 tons)	Net Sales (Millions of RMB)	% of Total	Sales Volume ('000 tons)	Net Sales (Millions of RMB)	% of Total
Synthetic Fibres	**337.0**	**4,711.7**	**9.4**	355.2	4,764.0	10.6	384.4	4,751.8	12.3
Resins and Plastics	**1,558.9**	**15,753.3**	**31.6**	1,505.8	13,958.3	30.9	1,409.7	12,086.0	31.3
Intermediate Petrochemicals	**1,009.3**	**6,775.7**	**13.6**	1,010.5	6,556.0	14.5	1,075.8	5,896.6	15.3
Petroleum Products	**5,109.8**	**19,387.6**	**38.8**	5,400.0	17,955.0	39.7	4,828.9	13,101.9	33.9
All others	**-**	**3,289.8**	**6.6**	-	1,957.0	4.3	-	2,827.8	7.2
Total	**8,015.0**	**49,918.1**	**100.0**	8,271.5	45,190.3	100.0	7,698.8	38,664.1	100.0

The following table sets forth a summary statement of the Group's income for the years indicated (prepared under IFRS):

	For the Years ended 31 December					
	2006		2005		2004	
	(Millions of RMB)	**% of Operating revenues**	(Millions of RMB)	% of Operating revenues	(Millions of RMB)	% of Operating revenues
Synthetic fibres						
Operating revenues	**4,727.3**	**9.3**	4,781.8	10.4	4,778.0	12.1
Operating expenses	**(4,531.0)**	**(9.0)**	(4,518.4)	(9.8)	(4,527.6)	(11.5)
Operating profit	**196.3**	**0.4**	263.4	0.6	250.4	0.6
Resins and plastics						
Operating revenues	**15,800.0**	**31.2**	14,010.3	30.5	12,154.4	30.8
Operating expenses	**(14,637.9)**	**(28.9)**	(12,519.6)	(27.3)	(10,267.8)	(26.0)
Operating profit	**1,162.1**	**2.3**	1,490.7	3.2	1,886.6	4.8
Intermediate petrochemicals						
Operating revenues	**6,800.6**	**13.5**	6,586.5	14.3	5,941.6	15.1
Operating expenses	**(6,120.2)**	**(12.1)**	(5,605.5)	(12.2)	(4,390.8)	(11.1)
Operating profit	**680.4**	**1.4**	981.0	2.1	1,550.8	3.9
Petroleum Products						
Operating revenues	**19,977.8**	**39.5**	18,616.5	40.5	13,692.4	34.8
Other income	**282.1**	**0.6**	632.8	1.4	-	-
Operating expenses	**(21,957.6)**	**(43.4)**	(19,696.2)	(42.9)	(12,705.8)	(32.3)
Operating profit	**(1,697.7)**	**(3.4)**	(446.9)	(1.0)	986.6	2.5
Others						
Operating revenues	**3,293.8**	**6.5**	1,960.8	4.3	2,836.2	7.2
Operating expenses	**(3,082.0)**	**(6.1)**	(1,721.0)	(3.7)	(2,485.4)	(6.3)
Operating profit	**211.8**	**0.4**	239.8	0.6	350.8	0.9
Total						
Operating revenues	**50,599.5**	**100.0**	45,955.9	100.0	39,402.5	100.0
Other income	**282.1**	**0.6**	632.8	1.4	-	-
Operating expenses	**(50,328.7)**	**(99.5)**	(44,060.7)	(95.9)	(34,377.4)	(87.2)
Operating profit	**552.9**	**1.1**	2,528.0	5.5	5,025.2	12.8
Share of profits/(losses) of associates and jointly controlled entities	**576.7**	**1.1**	(61.0)	(0.1)	(36.9)	(0.1)
Net financing costs	**(165.4)**	**(0.3)**	(179.4)	(0.4)	(292.0)	(0.7)
Income before tax	**964.2**	**1.9**	2,287.6	5.0	4,696.3	11.9
Income tax	**(53.2)**	**(0.1)**	(366.3)	(0.8)	(637.1)	(1.6)
Income after tax	**911.0**	**1.8**	1,921.3	4.2	4,059.2	10.3
Attributable to:						
Equity shareholders of the Company	**844.4**	**1.7**	1,850.5	4.0	3,971.1	10.1
Minority shareholders	**66.6**	**0.1**	70.8	0.2	88.1	0.2
Income after tax	**911.0**	**1.8**	1,921.3	4.2	4,059.2	10.3

Results of operations

Year ended 31 December 2006 compared with year ended 31 December 2005.

Net sales

Total net sales increased by 10.46% to RMB49,918.1 million in 2006 as compared with RMB45,190.3 million in 2005. In 2006, demand for petrochemical products remained strong, driving product prices to rise. However, the rise has since then slowed down remarkably. The weighted average prices of synthetic fibres, resins and plastics, intermediate petrochemicals and petroleum products for 2006 increased to varying degrees as compared to 2005.

(i) Synthetic fibres

Net sales of synthetic fibre products decreased by 1.10% to RMB4,711.7 million in 2006 as compared with RMB4,764.0 million in 2005. Although the weighted average price of synthetic fibres increased by 4.26%, the profit margin of synthetic fibre products was substantially reduced as the raw material costs of synthetic fibres remained at high levels. As such, sales volume of synthetic fibres decreased by 5.14% as compared to 2005 because the sales volume of certain major synthetic fibre products, except industrial fibre and acrylic top, decreased by varying degrees.

Net sales of synthetic fibre products accounted for 9.44% of the Group's total net sales in 2006, a decrease of 1.10 percentage points as compared to 2005.

(ii) Resins and plastics

Net sales of resins and plastics increased by 12.86% to RMB15,753.3 million in 2006 as compared with RMB13,958.3 million in 2005. Weighted average price of resins and plastics increased by 9.02% as compared to 2005 and sales volume increased by 3.52% as compared to 2005. Among the Group's resins and plastics products for 2006, sales volume of polyester pellet, polyethylene and polypropylene increased by 7.10%, 5.04% and 1.66%, respectively, while the Group's average sales prices had increased by 4.12%, 11.49% and 9.85%, respectively.

Net sales of resins and plastics accounted for 31.56% of the Group's total net sales in 2006, an increase of 0.67 percentage point as compared to 2005.

(iii) Intermediate petrochemicals

Net sales of intermediate petrochemicals increased by 3.35% to RMB6,775.7 million in 2006 as compared with RMB6,556.0 million in 2005, with weighted average price of intermediate petrochemicals increasing by 3.47% and sales volume decreasing by 0.11% as compared to 2005. Among the Group's intermediate petrochemical products, the weighted average prices of the Group's major products such as ethylene and butadiene increased by 15.09% and 7.40%, respectively, while the weighted average prices of pure benzene, ethylene glycol and ethylene oxide decreased by 6.87%, 7.62% and 11.86% respectively. The sales volumes of ethylene, butadiene, ethylene glycol and ethylene oxide decreased by 4.55%, 1.40%, 81.71% and 12.65%, respectively, except for pure benzene of which the sales volume increased.

Net sales of intermediate petrochemicals accounted for 13.57% of the Group's total net sales in 2006, a decrease of 0.93 percentage point as compared to 2005.

(iv) Petroleum products

Net sales of petroleum products increased by 7.98% to RMB19,387.6 million in 2006 as compared with RMB17,955.0 million in 2005, with an increase of 14.11% in the weighted average price as compared to 2005. The weighted average prices of gasoline, diesel oil and jet fuel increased by 18.01%, 10.98% and 22.13%, respectively, but sales volumes decreased by 7.95%, 12.60% and 15.68%, respectively. Petroleum products are subject to price control by the State.

Net sales of petroleum products accounted for 38.84% of the Group's total net sales in 2006, a decrease of 0.89 percentage point as compared to 2005.

The Group received a cash government grant of RMB282,141,800 from the Ministry of Finance of the PRC as a compensation for loss incurred due to the distortion of the correlation of domestic refined petroleum product prices and crude oil prices in 2006. There are no unfilled conditions or other contingencies attached to the receipt or usage of this government grant. However, there is no assurance that the Group will continue to receive such grant in the future.

(v) Trading and other activities

Revenues for trading and other activities increased by 68.10% to RMB3,289.8 million in 2006 as compared with RMB1,957.0 million in 2005. Such increases in revenue were mainly attributed to increases in trading volume of our petrochemical products.

Operating expenses

The Group's operating expenses comprise of cost of sales, selling and administrative expenses, other operating expenses and other operating income.

Such operating expenses increased by 14.23% to RMB50,328.7 million in 2006 as compared with RMB44,060.7 million in 2005. The operating expenses of synthetic fibres, resins and plastics, intermediate petrochemicals, petroleum products, and trading and other activities amounted to RMB4,531.0 million, RMB14,637.9 million, RMB6,120.2 million, RMB21,957.6 million and RMB3,082.0 million, respectively, representing increases of 0.28%, 16.92%, 9.18%, 11.48% and 79.08%, respectively as compared to 2005.

(i) Synthetic fibers

Operating expenses of synthetic fibres increased by RMB12.6 million as compared to 2005, mainly due to an increase in raw material prices for synthetic fibres.

(ii) Resins and plastics

Operating expenses of resins and plastics increased by RMB2,118.3 million as compared to 2005, mainly due to increased costs for raw materials such as ethylene and propylene. Moreover, sales volume of polyester chips increased by more than 30,000 tons or 7.10% as compared to 2005, which also contributed to the increase in cost of sales and selling expenses of resins and plastics.

(iii) Intermediate petrochemicals

Operating expenses of intermediate petrochemicals increased by RMB514.7 million as compared to 2005, due to increased costs for raw materials such as naphtha.

(iv) Petroleum products

Operating expenses of petroleum products increased by RMB2,261.4 million as compared to 2005, mainly due to the continuous increase in crude oil price (which is a major production raw material of the Group), which has directly led to a significant increase in cost of sales and selling expenses of petroleum products.

(v) Trading and other activities

Operating expenses of trading and other activities increased by RMB1,361.0 million as compared to 2005, which was attributable to increased purchasing costs as a result of increased business volume.

Cost of sales

Cost of sales increased by 14.68% to RMB49,182.2 million in 2006, as compared with RMB42,887.7 million in 2005. Cost of sales accounted for 98.53% of the net sales for 2006, primarily due to a significant increase in 2006 in crude oil price which is the Group's major raw material.

(i) Crude Oil

In 2006, the Group processed 8,920,300 tons of crude oil (of which 110,000 tons were processed on a sub-contracting basis), a decrease of 572,700 tons as compared with 9,493,000 tons in 2005 (274,000 tons of sub-contracting processing in 2005). The volumes of imported oil and offshore oil processed by the Group were 8,572,000 tons and 348,300 tons, respectively.

Total cost of crude oil processed by the Group in 2006 amounted to RMB33,307.6 million, an increase of 12.62% as compared with RMB29,576.4 million in 2005 and accounting for 67.72% of the cost of sales. The weighted average cost of crude oil for the Group was RMB3,780.56 per ton, representing an increase of 17.84% as compared to 2005. The weighted averaged costs of imported oil and offshore oil were RMB3,787 per ton and RMB3,636 per ton, respectively.

(ii) Other expenses

Expenses for other ancillary materials were RMB7,901.8 million in 2006, an increase of 13.63% as compared with RMB6,954.0 million in 2005, primarily due to a significant increase in the purchasing costs of intermediate petrochemicals such as liquified petroleum gas and propylene during the Reporting Period. Depreciation expenses increased from RMB1,714.4 million in 2005 to RMB1,848.5 million in 2006. Energy and power costs increased to RMB974.8 million due to increases in coal prices and electricity tariffs in 2006. Compared to the same period of 2005, labor costs increased to RMB1,210.3 million during 2006, while maintenance costs decreased to RMB874.5 million.

Selling and administrative expenses

Selling and administrative expenses amounted to RMB522.0 million, representing an increase of 17.46% as compared with RMB444.4 million in the same period of the previous year due to a significant increase in the Group's income from principal operations during the Reporting Period.

Operating profit

Operating profit was RMB552.9 million, representing a significant decrease of 78.13% as compared with RMB2,528.0 million in 2005 primarily due to a significant increase in the Group's production cost as a result of the rising crude oil price during the Reporting Period. As domestic petroleum product prices were subject to the State's control and were significantly below international prices, the Group witnessed a substantial decrease in operating efficiency in 2006.

Other operating income

Other operating income was RMB297.4 million in 2006, an increase of 24.64% as compared with RMB238.6 million in 2005, mainly due to the increase in income from fixed asset disposals and rental income from investment properties during the Reporting Period.

Other operating expenses

Other operating expenses increased by 19.35% from RMB201.5 million in 2005 to RMB240.5 million in 2006, primarily due to the increase in expenses on net losses from fixed asset disposals and the provision made for impairments of fixed assets during the Reporting Period.

Net financing costs

The Group's net financing costs were RMB165.4 million in 2006, a decrease of 7.80% as compared with RMB179.4 million in 2005, which was primarily due to the appreciation of RMB. A foreign exchange gain of RMB81.2 million was recorded during the Reporting Period, thereby lowering the Group's financing costs.

Profit before tax

The Group's profit before tax was RMB964.2 million in 2006, a decrease of 57.85% as compared with RMB2,287.6 million in 2005.

Income tax

The Group's income tax decreased by 85.48% to RMB53.2 million in 2006 as compared with RMB366.3 million in 2005. Such decrease was primarily due to a substantial decrease in total profit.

The Group continued to pay income tax at a preferential rate of 15% in 2006. This preferential rate was first applied to us under the approval of the State's tax authorities which became effective from 1 January 1993. According to the relevant taxation regulations issued by the Ministry of Finance and the State Administration of Taxation, the first nine H-Share listed companies (including the Company) were permitted to pay income tax at a 15% tax rate for the years of 1996 and 1997. From 1998 to 2006, this tax privilege has not been revoked by the relevant government authorities. However, the Group is unable to confirm whether the Ministry of Finance will maintain the 15% tax rate in 2007. In addition, in March 2007, the National People's Congress passed legislation under which the same taxation system will be applied to both domestic enterprises and foreign enterprises. The enterprise income tax rate is unified at 25% and will be effective from 1 January 2008. The impact of such change of enterprise income tax rate on the Group will depend on implementation details which will be subsequently issued.

Profit after tax

Profit after tax was RMB911.0 million in 2006, a significant decrease of 52.59% as compared with RMB1,921.3 million in 2005.

B. Analysis of the Company's principal operations and performance

(prepared under PRC Accounting Rules and Regulations)

(a) Principal operations by segment or product

By segment or product	Income from principal operations (RMB'000)	Cost of sales (RMB'000)	Gross profit margin (%)	Increase/ decrease of income from principal operations compared to last year (%)	Increase/ decrease of cost of sales compared to last year (%)	Increase/ decrease of gross profit margin compared to last year
Synthetic fibres	4,727,261	4,371,918	7.52	-1.14	0.44	Decrease 1.45 percentage points
Resins and plastics	15,800,015	13,741,514	13.03	12.77	18.14	Decrease 3.95 percentage points
Intermediate petrochemicals	6,800,577	5,597,796	17.69	3.25	11.40	Decrease 6.02 percentage points
Petroleum products	19,977,755	21,288,191	-6.56	7.31	12.31	Decrease 4.74 percentage points
Trading and others	3,173,828	2,923,012	7.90	66.81	78.19	Decrease 5.88 percentage points
Including: connected transactions	20,154,473	21,264,070	-5.51	1.43	11.78	Decrease 9.78 percentage points

Price-setting principles of connected transactions	The directors of the Company (including independent non-executive directors) believe that the connected transactions were conducted on normal commercial terms which are no less favourable than those offered to or by any third party and were conducted in ordinary course of business. This was confirmed by the independent non-executive directors of the Group.
Description on the necessity and continuity of connected transactions	The purchases by the Company from Sinopec Corp. and its associates of crude oil-related materials and sales of petroleum products by the Company to them were conducted in accordance with the State's relevant policy and applicable State tariffs or State guidance prices. As long as the State does not revoke its control over purchases of crude oil, sales of petroleum products and pricing thereof, such connected transactions will continue to happen. The Company sells petrochemicals to Sinopec Corp. and its associates and Sinopec Corp. and its associates act as an agency for the sale of petrochemicals in order to reduce the Company's inventories, expand its trade, distribution and sales networks and improve the Company's bargaining power with our customers. The Company accepts transportation, design, construction and installation, insurance agency and financial services from Sinopec and its associates in order to secure steady and reliable services at reasonable prices.

(b) Principal operations by geographical location

Geographical location	Income from principal operations RMB'000	Increase/decrease of income from principal operations compared to the previous year (%)
Eastern China	46,795,318	8.01
Other regions in China	3,449,778	35.59
Exports	234,340	172.13

C. Liquidity and Capital Resources

The Group's primary sources of capital are operating cash flows and loans from unaffiliated banks. The Group's primary uses of capital are costs of goods sold, other operating expenses and capital expenditures.

Capital Resources

Net cash inflows from operating activities (prepared under IFRS)

The Group's net cash inflows provided from operating activities amounted to RMB1,696.6 million in 2006, a decrease of RMB2,247.0 million as compared with RMB3,943.6 million in 2005. Due to the increase in the costs of the Group's crude oil which was higher than the increase in the sales prices of various major products during the Reporting Period, net cash inflows from profit before tax (net of depreciation) amounted to RMB2,787.9 million in 2006, representing a decrease of RMB1,204.8 million of net cash inflows as compared with RMB3,992.7 million in 2005. Increased inventories balance at the end of the year led to an increase in cash outflows of RMB48.3 million in 2006 (as compared with an increase in cash outflows of RMB387.2 million during the same period of the previous year). Changes in the year-end amounts of operating payables, other payables and bills payable led to a decrease in cash outflows of RMB345.6 million in 2006 (as compared with an increase in cash outflows of RMB33.9 million during the same period of the previous year). Increases in the year-end balances of debtors, bills receivables and deposits led to a decrease in operating cash inflows of RMB585.3 million in 2006 (as compared with an increase in cash inflows of RMB1,170.9 million during the same period of the previous year as a result of a decrease in such year-end balances). In addition, the Group's income tax payment decreased significantly due to a significant decrease in profit during the Reporting Period. In 2006, income tax payment led to a cash outflow of RMB63.4 million (as compared with RMB431.0 million cash outflow in 2005).

Cash flow breakdowns of the Group during the Reporting Period (prepared under PRC Accounting Rules and Regulations)

	2006 RMB'000	2005 RMB'000
Net cash inflow from operating activities	**2,040,679**	4,245,115
Net cash outflow from investing activities	**(1,352,541)**	(1,189,242)
Net cash outflow from financing activites	**(1,138,260)**	(3,395,755)

Borrowings

The Group's total borrowings in 2006 amounted to RMB5,334.0 million, representing a decrease of RMB70.0 million, of which short-term bank loans decreased by RMB669.8 million and long-term bank loans expired within one year decreased by RMB956.6 million. In addition, the Company has issued RMB2 billion short-term commercial papers to institution investors within the PRC inter-bank debenture market. The short-term commercial papers will mature on 12 December 2007. Short-term borrowings and loans were primarily used to meet the Group's needs of working capital during its production operation processes, among which, short-term bank loans carried floating interest rates denominated in Renminbi and short-term commercial papers carried a par interest rate of 3.83%. During 2006, the Group's long-term bank loans stood at RMB1,063.7 million in 2006, a decrease of RMB413.6 million. Most of the Group's long-term bank loans were used for capital expansion projects for the past years.

The Group managed to maintain its asset-liability ratio at a safe level by enhancing controls over both liabilities (including borrowings) and financing risks. The Group generally does not experience any seasonality in borrowings. Rather, due to the nature of the capital expenditures plan, long-term bank loans can be arranged in advance of expenditures while short-term borrowings are used to meet operational needs. The terms of our existing borrowings do not restrict the Group's ability to pay dividends on its shares.

Debt-equity ratio

The Group's debt-equity ratio was 5.3% in 2006 compared to 7.3% in 2005. The ratio is calculated using this formula: (total long-term loans)/(total long-term loans + shareholder's equity).

D. Research and Development, Patents and Licenses, etc.

The Group generates a number of technology development units, including the Petrochemical Research Institute, the Polyester Fiber Research Institute, the Acrylic Fibre Research Institute and the Environmental Protection Research Institute. These units are charged with various research and development tasks with respect to new technology, new products, new production processes and equipment and environmental protection. The Group's research and development expenditures in 2004, 2005 and 2006 were RMB74.7 million, RMB79.5 million and RMB51.6 million, respectively, representing approximately 0.2%, 0.2% and 0.1% of the total sales, respectively, in those years.

The Group was not, in any material aspect, bound by any patents; licenses; industrial, commercial or financial contracts; or new production processes.

E. Off-Balance Sheet Arrangements

Please refer to "Major events" headed "7. Guarantees" and note 31 to the financial statements under IFRS for details of the Group's external guarantee and capital undertakings.

F. Contractual obligations

The following table sets forth the Group's obligations to future payments under contracts as of 31 December 2006.

	As of 31 December 2006 Payment due by period				
	Total (RMB'000)	Less than 1 year (RMB'000)	1-3 years (RMB'000)	4-5 years (RMB'000)	After 5 years (RMB'000)
Contractual obligations					
Short-term loan	1,853,692	1,853,692	-	-	-
Long-term loan	1,480,299	416,645	1,059,043	4,611	-
Corporate bonds	2,000,000	2,000,000	-	-	-
Total contractual obligations	5,333,991	4,270,337	1,059,043	4,611	-

G. Description of substantial changes in the Company's major financial data during the Reporting Period as compared to the previous year (prepared under PRC Accounting Rules and Regulations)

(Details of reporting items with annual changes of 30% or more and occupying 5% or more of the Group's total assets at the reporting date or 10% or more of the total profit for the Reporting Period, together with reasons for the changes.)

Item	**Year ended 31December 2006 RMB'000**	Year ended 31December 2005 RMB'000	Change RMB'000	%	Reason for change
Profit from principal operations	**1,875,643**	3,527,005	-1,651,362	-46.82	Crude oil costs increased substantially; prices of major products remained sluggish; and profit margins of the oil refining business decreased substantially.
Profit from operations	**88,796**	1,723,162	-1,634,366	-94.85	
Net profit	**736,851**	1,704,627	-967,776	-56.77	
Subsidy income	**282,142**	632,820	-350,678	-55.42	The Company received a cash government grant of RMB282.1 million from the Ministry of Finance in December 2006, which was less than last year.
Investment income/(loss)	**673,809**	(39,375)	713,184	-	Investment gain from Shanghai Secco Petrochemical Company Limited increased substantially.

Item	As at 31December 2006 RMB'000	As at 31December 2005 RMB'000	Change RMB'000	%	Reason for change
Construction in progress	**1,972,893**	754,192	1,218,701	161.59	Increase in investment in the 3.3 million tons/year diesel hydrogenation project and the 380,000 tons/year ethylene glycol project

H. Analysis of the Reporting Period's performance and results of the companies in which the Company has controlling interests or investment interests

As at 31 December 2006, the Company had equity interests of more than 50% in the following principal subsidiaries:

Company	Place of registration	Principal Activities	Place for principal activities	Class of legal person shares	Percentage of the equity held by the company	Percentage of the equity held by subsidiaries (%)	Registered Capital ('000)	Net Profit/ (loss) for 2006 ('000)
Shanghai Petrochemical Investment Development Company Limited	China	Investment management	China	Limited company	100	-	RMB800,000	233,516
China Jinshan Associated Trading Corporation	China	Import and export of petrochemical products and equipment	China	Limited company	67.33	-	RMB25,000	18,273
Shanghai Golden Way Petrochemical Company Limited	China	Production of vinyl acetate products	China	Limited company	-	75	US$3,460	(1,337)
Shanghai Jinchang Engineering Plastics Company Limited	China	Production of polypropylene compound products	China	Limited company	-	50.38	US$4,750	3,248
Shanghai Golden Phillips Petrochemical Company Limited	China	Production of polypropylene products	China	Limited company	-	60	US$50,000	185,591
Zhejiang Jin Yong Acrylic Fiber Company Limited	China	Production of acrylic fiber products	China	Limited company	75	-	RMB250,000	(47,532)
Shanghai Petrochemical Enterprise Development Company Limited	China	Investment management	China	Limited company	100	-	RMB455,000	(66,139)
Shanghai Golden Conti Petrochemical Company Limited	China	Production of Petrochemical products	China	Limited company	-	100	RMB545,776	43,335

None of the subsidiaries have issued any debt securities.

The Company's equity interests in its associates comprised of an equity interest of 38.26%, amounting to RMB661.4 million, in Shanghai Chemical Industry Park Development Co., Ltd. set up in the PRC; and an equity interest of 20%, amounting to RMB1,881.8 million, in Shanghai Secco Petrochemical Company Limited set up in the PRC. The principal business of Shanghai Chemical Industry Park Development Co., Ltd. is the planning, developing and operating the Chemical Industry Park in Shanghai, PRC, while the principal business of Shanghai Secco Petrochemical Company Limited is production of petrochemicals such as ethylene.

Results analysis of the companies in which the Group has controlling interests or investment interests and which affected 10% or more of the Group's net profit:

1. Shanghai Golden Phillips Petrochemical Company Limited, which mainly engaged in the production of polyethylene filament products and specialized materials, recorded income from principal operations of RMB1,532.0 million and a profit from principal operations of RMB249.8 million in 2006; and

2. Shanghai Secco Petrochemical Company Limited, which primarily engaged in the production and distribution of petrochemicals, recorded income from principal operations of RMB21,777.4 million and a profit from principal operations of RMB3,751.7 million in 2006.

I. Major suppliers and customers

The Group's top five suppliers in 2006 were Sinopec Transport & Storage Branch, China International United Petroleum & Chemical Company Limited, Sinochem International Oil Corporation, Shanghai Secco Petrochemical Company Limited and China National Offshore Oil Corporation. Total costs of purchases from these suppliers accounted for 77% of the total cost of purchases by the Group during the year, amounting to RMB37,861.2 million. The cost of purchases from the largest supplier amounted to RMB25,240.7 million, representing 51% of the total costs of purchases by the Group during the year.

The Group's top five customers during 2006 were Sinopec Huadong Area Sales Company, Sinopec Gaoqiao Branch, Shanghai Chlor-Alkali Chemical Company Limited, Shanghai Xinshan Chemical Industry Company Limited and Shanghai Secco Petrochemical Company Limited. The total sales derived from these customers represented 38% of the Group's total turnover during the year, amounting to RMB19,368.4 million. The sales derived from the largest customer amounted to RMB15,846.7 million, representing 31% of the turnover during the year.

To the knowledge of the Board, none of the directors (or their associates) or shareholders of the Company held any interest in the above suppliers and customers, namely Sinochem International Oil Corporation, China National Offshore Oil Corporation, Shanghai Chlor-Alkali Chemical Company Limited or Shanghai Xinshan Chemical Industry Company Limited. Sinopec Transport & Storage Branch, China International United Petroleum & Chemical Company Limited, Sinopec International Co. Ltd., Sinopec Huadong Area Sales Company and Sinopec Gaoqiao Branch are subsidiaries of the Company's controlling shareholder, Sinopec Corp. The Company owns an equity interest of 20% in Shanghai Secco Petrochemical Company Limited.

J. Others

Employees

As at 31 December 2006, the Company had 22,922 employees, among whom 14,180 were production staff; 7,162 were sales, finance and other staff; and 1,580 were administrative staff. 27.56% of the Group's staff were graduates of colleges or universities. The Group was responsible for pension for retirees amounting to 11,164 people.

Purchase, Sale and Investment

Save and except as disclosed in the annual report, there was no material purchase or sale of our subsidiaries or associated or any other material investments during 2006.

Pledge of Assets

As at 31 December 2006, no fixed asset was pledged by the Group (31 December 2005: RMB nil).

Accounting principles generally accepted in the United States of America ("U.S. GAAP") Reconciliation

The financial statements prepared in accordance with IFRS differ in certain significant respects from U.S. GAAP. Please see section D for supplementary information for North American shareholders. As a result of these differences and the effect upon taxation, profit attributable to equity shareholders of the Company reported under U.S. GAAP was higher than profit attributable to equity shareholders of the Company reported under IFRS by RMB5.6 million in 2006, RMB18.9 million in 2005 and RMB175.0 million in 2004. Shareholders' equity reported under U.S. GAAP was higher than the one reported under IFRS by RMB86.7 million as of 31 December 2006 and higher by RMB81.1 million as of 31 December 2005.

Company's Outlook on Future Developments (Business Prospects)

1. The industry's trend and competition posed to the Company

In 2007, the global situation is generally in a state of moderation and stability. After consecutive years of fast economic growth, the growth of the world economy is expected to slow down in 2007. Through continuous strengthening and enhancement of macro-economic measures, the economy of China is likely to maintain a steady and relatively fast growth. The steady and robust economic growth in both the international and domestic economies will bring about good development potentials to the petroleum and petrochemical industry. The domestic petrochemicals market is expected to remain prosperous due to gradually increasing demand for petroleum, natural gas, petroleum products and major petrochemicals, as driven by strong economic growth. However, petrochemical companies will still be exposed to a number of challenges as follows: the fact that international crude oil prices are expected to continue to fluctuate at high levels; the State's refusal to loosen the control over prices of domestic petroleum products; intensifying market competition caused by rapid expansion of the petrochemicals production capacity, both domestically and overseas; further reduction of tariffs for imported petrochemicals amid further opening of the petroleum distribution market; intensification of international trade barriers and trade conflicts; and increasing pressure from environmental protection requirements. All the above factors will have certain impact on the production operation of the petrochemical industry in China, adding risks to the operation of petrochemical companies.

In response to the changes in the foreign and domestic macro-economic environment, the Group will strive to intensify reform programs, carry out restructuring, capitalize on business opportunities and accelerate development. It will also enhance management and regulate operation, striving to continue to achieve satisfactory operating results in 2007.

2. The Company's opportunities, challenges and strategies ahead

2007 will be a crucial period for the implementation of China's Eleventh Five-year Plan, during which economic globalization will increase. Between 2005 and 2010, the world's economy is expected to grow at an annual average rate of between 3% and 4%, whereas demand for petroleum will grow at an annual average rate of 1% to 2% and demand for ethylene will maintain an annual average growth rate of 4% to 5%. China's economy will be able to maintain its steady and strong growth, with GDP per capita doubling by 2010 over 2000.

For China's petroleum and petrochemical industry, the Eleventh Five-year Plan on one hand presents room for massive development and a rare opportunity for strategic development: further development and enhancement on the reforms of the socialist market economy; acceleration of the four "-izations" (industrialization, urbanization, marketization, internationalization); gradual development toward a fully open market; diversification of the investment systems; gradual formation of a dominant market economy and so forth. On the other hand, the industry also faces challenges such as more severe constraints over resources, increasing pressure on sustainable development, lack of self-developed intellectual property, intensifying market competition, and so forth.

During the period of the Eleventh Five-year Plan, the Group will base on a scientific development vision to persist with the development objective of "becoming a first-class China enterprise and an advanced corporation internationally and building a modernized petrochemical enterprises with world-class competitiveness". The Group will be committed to matching external expansion with internal development and focusing on internal development as its mission, fully implementing the cost-reduction strategy. Through development of the structural adjustment program, the Group will effectively correct deficiencies such as inferior ancillary capacity in oil refining and the lack of rationality in petrochemical product structure and energy and power structure. Through integrated efforts on technological advancement and structural adjustments, quality enhancement and effective cost reduction, the Group will achieve transformation and renewal of its obsolete facilities and optimization and upgrade of its business structure, thereby further capitalizing on the Group's core operations and enhancing its overall competitiveness and economic efficiency.

3. New business initiatives for 2007

In 2007, in the face of continued volatility of international crude oil prices at higher levels and a possible decline in prices of petrochemicals and intensifying competition, the Company will aim for a full implementation of its cost-reduction strategy and strive for the building of a harmonious enterprise. It will accelerate the development of the structural adjustment program; optimize various resources; enhance fundamental management, infrastructure and basic training; ensure safety and environmental protection; emphasize energy savings and consumption reduction; push forward various reforms; and further enhance the development of team structure and corporate culture, with a view to achieving fundamental improvement of economic benefits.

i. Push forward safety and environmental protection work to ensure smooth and effective production operations

The Group will focus on resolving complicated issues such as frequent repairs and maintenance of production facilities throughout the year; shortage of intermediate materials and electricity; further decline in quality of crude oil for processing; multiplicity of development projects, and so forth, with a view to putting more regard to the work on safety, environmental protection and stable production. The Group will further enhance its safety and environmental protection management level, so as to prevent harmful incidents involving safety, environmental protection and occupational hazards; further strengthen professional management of various aspects, raising the operating factor and load factor of major production facilities to achieve safe, stable and long-cycle operation of production facilities; further elevate its efforts on optimization of resource allocation, operating approaches, energy structure and product structure so as to strive to reduce procurement costs of crude oil, large amount of petrochemical raw materials and fuel, thus lowering the operating costs for production facilities and costs for various production operations.

ii. Accelerate the development of the structural adjustment program and advance technological innovations, thus striving for enhancement of corporate competitiveness

The Group will further adjust and optimize the business structure, product structure and energy and power structure through the development of its structural adjustment program, so as to maintain the integral competitive edge of its integrated oil refining and petrochemical operations. It will further strengthen its innovation efforts to accelerate development and application of new technologies and new products through a push for technological advancement. The Group will, whilst working on its production operation and corporate development, also push forward technological development and innovations on energy saving, consumption reduction and emission reduction. It will continuously enhance its information technology work, with a focus on the optimization of the ERP and production management, so as to strive for the enhancement of the Company's competitiveness in various aspects including operating scale, cost, technological quality and production quality.

iii. Strengthening internal management continuously to further elevate the Company's operational efficiency

The Group will further enhance its business procedures, increase working efficiency, strengthen internal control and prevent operating risks through the development and application of scientific and effective management systems and methods. The Group will maintain thorough budget management and earnestly implement the new accounting rules, ensuring the timeliness, completeness and accuracy of financial and production operation figures. It will continue to enhance the management system based on internal control system, pushing forward a full implementation of the internal control system to all aspects, all staff and all procedures within the Company. It will continue to improve fundamental management, infrastructure and basic training to consistently systematize, standardize and regularize the measures on frontline staff's self-improvement efforts.

iv. Continue to carry out reforms such as clean-up and shake-up investment at subsidiary level, restructuring and segregation in a pro-active and consistent manner

The Group will continue with its drive on clean-up and shake-up investment at subsidiary level effort, accelerating the process of bankruptcies, mergers, restructuring and withdrawals, in order to effectively resolve the issues inherited from the past regarding auxiliary businesses and external investments. It will continue to carry out the divestiture of auxiliary businesses from the core businesses, as well as other system reform and segregation work, in a gradual manner, focusing on resolving the reform and segregation of the maintenance and repair operation and striving for basic completion of the transformation of auxiliary businesses. At the same time, the Group will gradually push forward the structural reform of the core businesses, with an aim to complete the management consolidation on the operation aspect and the centralized management of certain functions (businesses).

v. Further strengthening the establishment of team structure and the promulgation of corporate culture, thereby promoting the development of corporate harmony

The Group will reinforce the cultivation of management leaders by stepping up their learning, execution ability and control ability. It will strengthen the establishment of team structure according to the practical needs of business structure adjustment, with a focus on further raising the quality of the three core teams (management, professionals and skilled operators). The Group will further push forward the promulgation of corporate culture and enhance the development of corporate harmony, based on the requirements of the "Implementation Guidelines on Corporate Culture Cultivation for Shanghai Petrochemical".

4. The risks to which the Company may be exposed to in its future development

(i) The cyclical characteristics of the petroleum and petrochemical industry as well as the volatility of crude oil and refinery products' prices may have an adverse impact on the Group's operation and production.

A large part of the Group's revenue is derived from the sale of petrochemicals. Historically, such products have been cyclical in nature and sensitive towards the supply and prices of raw materials as well as towards the overall economic situations. The markets where many of the Group's products are available respond sensitively to changes in industrial output and output level, the conditions of regional and global economies, cyclical changes in the prices and supply of substitutes, and changes in consumer demand. The above factors have a major impact, from time to time, on the prices of the Group's products available on the regional and global markets. Historically, these markets have experienced short supply during various periods which led to an increase in prices and profits, followed by a period of increased output which might result in oversupply and a decline in prices and profits. Given the reduction of tariffs and other import restrictions as well as China's relaxed control over the distribution and pricing of products, many of the Group's products will be subject to the impact of the petrochemical cycle of the regional and global markets. In addition, the prices of crude oil and petrochemicals will remain volatile and uncertain. Increased crude oil prices and fallen petrochemicals prices are likely to have an adverse impact on the Group's business, operating results and financial condition.

(ii) Substantial capital expenditures and financing requirements are needed for the Group's development plans, presenting a number of risks and uncertainties.

The petrochemical industry is a capital intensive sector. The Group's capability to maintain and increase income, net income and cash flows has a bearing upon ongoing capital expenditures. The Group's capital expenditures amounted to approximately RMB2,008.8 million (US$257 million) for 2006, which were met by financing activities and part of the Group's internal funds. As at 31 December 2006, Sinopec Corp. (as the Group's controlling shareholder) provided guarantee to the Group's US$2.7 million long-term borrowings.

The Group's capability to secure external financing in future is subject to a number of uncertainties which include:

- the Company's operating results, financial condition and cash flow in future;
- China's economic conditions and the market conditions for the Group's products;
- financing costs and conditions of the financial market; and
- grant of government approval documents and other risks associated with the development of infrastructure projects in China, and so forth.

The Company's failure to secure sufficient financing required for operation or development plans may have an adverse impact on the Group's business, operating results and financial condition.

(iii) The Group may be exposed to intensifying competition.

Eastern China, a major market of the Group, has been experiencing a stronger economic growth and a higher demand for petrochemicals than other regions, which the Company believes, will prompt rival petrochemical companies to attempt to expand their sales and set up their sales networks in our major markets. This tendency is believed to continue and may intensify. Intensifying competition may have a material adverse impact on the Group's financial condition and operating results.

(iv) The Group may not be able to pass on all increased costs due to rising crude oil prices.

At present, a significant amount of crude oil is being consumed by the Group for the production of petrochemical products. The Group attempted to mitigate the effect of increased costs due to rising crude oil prices by passing on the increased costs to the Group's customers. However, whether the Group's ability to pass on the increased costs to its customers is subject to the market conditions and the State's control. Because there was a time lag between rising crude oil prices and increasing petrochemical products prices, rising crude oil prices cannot be totally offset by increasing the sales prices of the Group's products. This may have a major adverse impact on the Group's financial condition, operating results or cash flow.

(v) The Group's business operations may be affected by existing or future environmental protection regulations.

The Group is subject to the scrutiny of a number of environmental protection laws and regulations in China. Such laws and regulations permit the government to:

- levy a tax on emission of wastes;
- levy a fine and a charge on acts that have seriously damaged the environment; and
- shut down any facilities which are not in compliance with the law, and request that a rectification be made or that the operation which is damaging the environment be suspended, all of which at the judgment of the Central Government.

Wastes are produced during the Group's production operation. Besides, operating permits are required for the Group's production equipment, and such permits may be subject to renewal, revision or revocation. The Group's operations are in full compliance with all applicable Chinese environment protection laws and regulations already promulgated and being enforced. However, the State has already enforced strict laws and environmental standards and may enforce stricter laws and stricter environmental standards. The Group cannot assure that the State or local governments will not enact more regulations or more strictly enforce certain (existing) regulations which may cause additional expenses on environmental protection measures.

(vi) The Group will be under a longstanding impact of competition and imported products from foreign companies upon China's accession to the World Trade Organization ("WTO").

As a member state of WTO, China has undertaken to lift or reduce some tariffs and non-tariff barriers imposed on foreign players in the Chinese domestic petrochemical market, while such barriers used to benefit us. In particular, the tax rates of tariffs imposed on imported petrochemicals which are in competition with the Group's products have been reduced, and

- participation by foreign companies in investing in China's domestic petrochemical industry has been permitted to increase;
- restrictions on import of crude oil by non-state-owned companies will be relaxed gradually;
- foreign investment enterprises will be granted with the right to import and trade in petrochemical products; and
- foreign companies will be permitted to distribute and market petroleum products in China's domestic retail and wholesale markets.

If these measures are implemented, the Group will consistently be affected by intensified competition and import from overseas. The Group believes that China's accession to the WTO will bring about a substantial amount of investments and businesses to China and accordingly, more opportunities will be available for the Group's product sales. The Group also truly believes that its products have been and will be able to maintain their competitiveness against products imported into China. However, tariff breaks on imported products may reduce the cost of imported products or may have an adverse impact on the revenues from the sale of some of our products, including a small number of major products. On the other hand, the PRC government may also lower the tariffs on our production equipment to be imported by us in future and lift the existing restrictions on the use of imported raw materials. Although the Group is confident that it is able to capitalize on new sales opportunities, the eventual impact of China's accession to the WTO on our business and operating results remains to be seen.

(vii) The Group's profits, dividends and cash and cash equivalents may be reduced due to fluctuations in the value of the Renminbi.

While the official exchange rate of the Renminbi against the US dollar has been relatively stable and the Renminbi has considerably appreciated against the US dollar in recent years, the value of the Renminbi against the US dollar and other currencies may fluctuate in the future. Historically, the People's Bank of China has set the conversion of Renminbi into foreign currencies, including US dollars. On July 21, 2005, the PRC government significantly changed its policy of pegging the value of the Renminbi to the US dollar by permitting the Renminbi to fluctuate within a narrow band against a basket of certain foreign currencies. Since the adoption of this new policy, the value of the Renminbi against the US dollar has fluctuated daily within a narrow band, but overall has appreciated against the US Dollar. In addition, the PRC government continues to receive significant international pressure to further liberalize its currency policy and as a result may further change its currency policy. A small portion of our cash and cash equivalents is denominated in foreign currencies, including the US dollar. Any increase in value of the Renminbi against other currencies, including the US dollar, may decrease the Renminbi value of our cash and cash equivalents that are denominated in foreign currencies. On the other hand, most of our revenues is denominated in Renminbi but a major part of our procurement of crude oil, certain equipment and certain debt repayments are denominated in foreign currencies. Any devaluation of the Renminbi in the future will increase our costs and jeopardize our profitability. Any devaluation of the Renminbi may also have an adverse impact on the value of dividends payable in foreign currencies by the Company for H shares and American Depository Receipts.

(viii) Risks of the possibility of a higher tax rate.

The charge for PRC income tax is currently calculated at the rate of 15%, and the Company has not received any notification by the Ministry of Finance in respect of any change to the tax rate. However, the risk of a possible increase in the tax rate of the Company in 2007 may not be ruled out. Additionally, the "Enterprise Income Tax Law of The People's Republic of China", which aims at unifying the tax rates for domestic and foreign enterprises, was passed by polling on 16 March 2007 at the fifth meeting of the tenth session of The National People's Congress and will take effect from 1 January 2008. The unified enterprise income tax rate will be 25%. The impact of such change of enterprise income tax rate on the Group will depend on detailed pronouncements that are subsequently issued. Since implementation and transitional guidance applicable to the Group has not yet been announced, the Group cannot reasonably estimate the financial impact of the new law to the Group at this stage.

(ix) Risks regarding the control by the majority shareholder.

Sinopec Corp., the controlling shareholder of the Group, owns 4,000,000,000 shares of the Group, representing 55.56% of the total share capital of 7,200,000,000 shares and assumes an absolute controlling position. Sinopec Corp. may, by taking advantage of its controlling position, exercise influences over the Group's production operation, funds allocations, appointments or removals of senior staff, etc, thereby producing an adverse impact on the Group's production operation as well as shareholders' interests.

(x) Risks regarding the failure to complete the share reform.

According to the China Securities Regulatory Commission's ("CSRC") requirement, the Company should have implemented certain share reforms and have begun execution of such reforms by October 2006. However, the Company's share reform proposal failed to obtain approvals by shareholders of the circulating A shares because such shareholders were not satisfied with the share reform proposal. According to relevant regulations, starting from 8 January 2007, Shanghai Stock Exchange began to adopt a special arrangement of differentiated systems for listed companies that were unable to complete share reform. The first step of the arrangement is that the range of share price movement for such stocks were unitarily adjusted up or down by 5%, with a trading information disclosure system equivalent to that of ST and ST* stocks applied for such stocks. In the future, depending on market conditions, there may be further arrangements of differentiated systems in a gradual manner for companies which have not yet completed the share reform. In addition, CSRC will keep paying special attention to the implementation of share reform by the listed companies which have not yet implemented share reform when reviewing any securities-related applications by such listed companies, their substantial shareholders or ultimate controllers. Such regulations may have an adverse impact on the operating environment, market image and market financing activities of the Group.

Possible changes to accounting policies and accounting estimates after the adoption of the New Accounting Standards and resulting impact on the Company's financial position and operating results:

On 1 January 2007, the Group has adopted the Accounting Standards for Business Enterprises (the "New Accounting Standards") announced by the Ministry of Finance ("MOF") of the People's Republic of China (the "PRC") on 15 February 2006 and ceased to apply the current Accounting Standards for Business Enterprises and "Accounting Regulations for Business Enterprises" (the "Current Accounting Standards"). The adoption of the New Accounting Standards by the Group may result in changes to accounting policies and accounting estimates determined under the Current Accounting Standards, and there may be impact on the Group's financial position and operating results.

i. Analysis on the differences of consolidated shareholders' equity under the Current Accounting Standards and the New Accounting Standards as at 1 January 2007, being the date of implementation of the New Accounting Standards:

According to the regulations as stated in Cai Kuai [2006] No.3 "Notice on the Publication of 38 Detailed Standards Starting from 'Accounting Standards for Business Enterprises No.1 - Inventories'" released by MOF on 15 February 2006, the Company should adopt the New Accounting Standards from 1 January 2007. According to the MOF's regulations on the New Accounting Standards, the Company has currently identified the differences between the Current Accounting Standards and the New Accounting Standards as at 1 January 2007, being the date of implementation of the New Accounting Standards, as follows:

a Financial assets available for sale to be stated at fair value

According to the Group's announcement on 8 December 2006, the Group agreed to transfer its entire equity interests in China Everbright Bank and Bank of Shanghai to Sinopec Finance Company Limited. Accordingly, the two investments should be re-classified as financial assets available for sale and stated at fair value basis. The positive difference of RMB25,822,113 between the fair value of RMB81,118,000 and the book value of RMB55,296,587 increases shareholders' equity as at 1 January 2007.

b. Income tax

Due to the financial assets available for sale as aforementioned (a) and capitalisation of general borrowing costs mentioned in (d) the deferred tax liabilities of RMB24,671,867 were generated and reduced shareholders' equity as at 1 January 2007.

c. Minority interests

Minority interests amounted to RMB336,013,000 as at 31 December 2006, according to the consolidated balance sheet prepared under the Current Accounting Standards. Under the New Accounting Standards such amount shall be accounted for as shareholders' equity and accordingly shareholders' equity shall increase by such amount as at 1 January 2007.

d. Capitalisation of general borrowing costs

To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the borrowing costs should be capitalised as part of the cost of that asset. The Company shall increase fixed assets and construction in progress by RMB138,657,000 and increases shareholders' equity on 1 January 2007.

ii. In addition to the above-mentioned differences, possible changes to accounting policies and accounting estimates after the adoption of the New Accounting Standards and resulting impact on the Company's financial position and operating results are set out below:

a. Long-term equity investments

According to the regulations of "Accounting Standards for Business Enterprises No.6 - Long-term Equity Investments", the Company's subsidiaries are accounted for using the cost method instead of the equity method under the Current Accounting Standards, and revisions will be made on the basis of equity method during the preparation of consolidated financial statements. This policy change will reduce the impact of the subsidiaries' operating profits and losses on the Company's current investment gains, but there will be no impact on the Group's consolidated financial statements.

b. Capitalisation of borrowing costs

According to the regulations of "Accounting Standards for Business Enterprises No.17 - Borrowing Costs", the scope of the Company's assets eligible for capitalisation are changed from fixed assets and development products of property development enterprises, as classified in the Current Accounting Standards, to all fixed assets, investment properties and inventories, and so forth, which require a considerably long period of construction or production to achieve the expected usable or saleable state. This policy change will expand the scope of capitalisation of the Group and enhance the profit and shareholders' equity of the current term.

c. Investment properties

According to the regulations of "Accounting Standards for Business Enterprises No.3 - Investment Properties", investment properties accounted for as fixed assets under the Current Accounting Standards will be accounted for as investment properties. The Group uses the cost method to account for investment properties, and this item has no impact on the Group's profit and shareholders' equity.

iii. The aforementioned differences and impacts may be further revised in accordance with MOF's further elaboration of the New Accounting Standards.

Investments by the Company

1. Application of Capital Raised

   The Company did not raise capital or use the previous capital raised during the Reporting Period.

2. Projects from non-raised capital

   In 2006, the capital expenditure of the Group amounted to RMB2,008.8 million, representing an increase of 75.76% or RMB865.9 million as compared to RMB1,142.9 million in 2005. Major projects include the following:

Project	Total project investment RMB million	Project progress as at 31 December 2006
380,000 tons/year ethylene glycol porject	1,249.0	Under construction
3,300,000 tons/year diesel hydrogenation project	528.0	Under construction
Total	1,777.0	-

The Group's capital expenditure for 2007 is estimated at approximately RMB2,500 million.

Reasons for changes in accounting policies, accounting estimates or amendments to major accounting errors of the Company and the impacts thereof

During the Reporting Period, The Company did not make any changes to accounting policies, accounting estimates or major accounting errors.

Daily Operation of the Board

1. The convening and the resolutions of the Board meetings

(i) The eighth meeting of the fifth session of the Board was convened on 24 January 2006 by means of correspondence. Announcement whereof was published in "China Securities Journal", "Shanghai Securities News", "South China Morning Post" and "Hong Kong Commercial Daily" on 25 January 2006.

(ii) The ninth meeting of the fifth session of the Board was convened on 23 February 2006 by means of correspondence. At the meeting, the Board considered and approved the proposed signing of a joint venture agreement between the Company and BOC (China) Investment Co., Ltd. to jointly invest in and establish Shanghai Petrochemical BOC Gas Co., Ltd. (the "JV"), with 12 voted in favor, 0 voted against and 0 abstained. The investment cost of the JV was US$80 million, with a registered capital of US$32 million. Each party to the JV will contribute 50% of the capital, and the Company's contribution will be made in Renminbi in an amount equivalent to US$16 million, in the form of the relevant assets of the Company's existing air separation facilities. According to the appraisal report (Zhong Zheng Ping Bao Zi [2005] No.59) issued by Beijing Zhong Zheng Appraisal Co., Ltd. on 4 November 2005, the appraised value of the relevant assets was RMB255.4 million as at 30 September 2005, and the amount in excess of the Company's obligatory contribution will be purchased by the JV.

(iii) The tenth meeting of the fifth session of the Board was convened on site on 24 March 2006. Announcement whereof was published in "China Securities Journal", "Shanghai Securities News", "South China Morning Post" and "Hong Kong Commercial Daily" on 27 March 2006.

(iv) The eleventh meeting of the fifth session of the Board was convened on 26 April 2006 by means of correspondence. Announcement whereof was published in "China Securities Journal", "Shanghai Securities News", "South China Morning Post" and "Hong Kong Commercial Daily" on 27 April 2006.

(v) The twelvth meeting of the fifth session of the Board was convened on site on 15 June 2006. Announcement whereof was published in "China Securities Journal", "Shanghai Securities News", "South China Morning Post" and "Hong Kong Commercial Daily" on 16 June 2006.

(vi) The thirteenth meeting of the fifth session of the Board was convened on site on 29 August 2006. Announcement whereof was published in "China Securities Journal", "Shanghai Securities News", "South China Morning Post" and "Hong Kong Commercial Daily" on 30 August 2006.

(vii) The forteenth meeting of the fifth session of the Board was convened on site on 12 October 2006. Announcement whereof was published in "China Securities Journal", "Shanghai Securities News", "South China Morning Post" and "Hong Kong Commercial Daily" on 16 October 2006.

(viii) The fifteenth meeting of the fifth session of the Board was convened on site on 26 October 2006. Announcement whereof was published in "China Securities Journal", "Shanghai Securities News", "South China Morning Post" and "Hong Kong Commercial Daily" on 27 October 2006.

(ix) The sixteenth meeting of the fifth session of the Board was convened on 3 November 2006 by means of correspondence. At the meeting, the Board considered and approved the proposed disposal of the Company's entire holding of 41,100,506 China Everbright Bank shares at China Beijing Equity Exchange for an upset price of RMB66,993,800 as indicated by the appraisal report Yue Ping Bao Zi (2006) B093-053 issued by Yue Hua CPAs, with 12 voted in favor, 0 voted against and 0 abstained. The Board also considered and approved the disposal of the equity interest in Bank of Shanghai held by the Company's subsidiaries at China Beijing Equity Exchange in accordance with the appraised values indicated by the appraisal report issued by Yue Hua CPAs, with 12 voted in favor, 0 voted against and 0 abstained. Details of the equity interests are as follow:

(a) the 3,074,900 shares bearing an appraised value of RMB12,145,900 (Yue Ping Bao Zi [2006] B093-056) held by the Company's wholly-owned subsidiary Shanghai Petrochemical Enterprise Development Company Limited ("Shanghai Petrochemical Enterprise");

(b) the 501,000 shares bearing an appraised value of RMB1,979,000 (Yue Ping Bao Zi [2006] B093-057) held by the Company's wholly-owned subsidiary Shanghai Petrochemical Investment Development Company Limited;

(c) the 153,100 shares bearing an appraised value of RMB604,700 (Yue Ping Bao Zi [2006] B093-055) held by Shanghai Petrochemical Haisheng Assembly Company Limited, a subsidiary of the Company's wholly-owned subsidiary Shanghai Petrochemical Enterprise.

2. Board's execution of resolutions made at shareholders' meetings

Three shareholders' meetings were convened during the Reporting Period. The Board strictly handled all matters within the scope of authorization as approved by the shareholders' meetings and faithfully executed the resolutions made thereat.

(i) The 2005 Profit Appropriation Plan of the Company was implemented in accordance with the resolution made at the 2005 annual general meeting.The announcement on dividend payment for A shares was published in the China Securities Journal and Shanghai Securities News on 10 July 2006. Dividends for A shares and H shares were paid on 20 July 2006. Other resolutions were executed faithfully.

(ii) Pursuant to the first extraordinary general meeting in 2006, the Company issued the first tranche of RMB1 billion short-term commercial papers on 23 February 2009, for a term of nine months with maturity on 21 November 2006; the second tranche of RMB 2 billion was issued on 11 December 2006, for a term of one year with maturity on 12 December 2007.

Plan for Profit Appropriation or Additions to Statutory Reserves by the Board

Net profit of the Company for the year 2006 amounted to RMB736,851,000 under PRC Accounting Rules and Regulations (profit attributable to equity shareholders of the Company amounted to RMB844,407,000 under IFRS). After RMB73,685,000 was made to the statutory surplus reserve, profit available for distribution to shareholders amounted to RMB663,166,000 (RMB770,722,000 under IFRS). The Board proposed to declare a final dividend of RMB0.40 (inclusive of tax) per 10 shares. With reference to the total number of shares of 7,200,000,000 for the year ended 31 December 2006, the total dividend amount will be RMB288 million.

Audit Committee

The Audit Committee reviewed with the management the accounting principles and standards adopted by the Company and discussed matters regarding auditing, internal control and financial reporting, including a review of the audited annual report for the twelve months ended 31 December 2006.