

REPORT OF THE DIRECTORS

20

The directors are pleased to present their annual report and the audited consolidated financial statements for the year ended 31 December 2006.

PRINCIPAL ACTIVITIES

The principal activity of the Company is investment holding. The principal activities of its principal subsidiaries are the exploration and production of crude oil and natural gas in the People's Republic of China ("PRC"), the Republic of Kazakhstan, the Sultanate of Oman, Peru, the Kingdom of Thailand, the Azerbaijan Republic, the Republic of Indonesia and the Union of Myanmar.

RESULTS AND APPROPRIATIONS

The results of the Group for the year are set out in the consolidated income statement on page 28.

A final dividend for the year ended 31 December 2005 of HK8 cents per share amounting to HK\$386,727,000 was paid during the year. The directors recommend the payment of a final dividend of HK10 cents per share for the year ended 31 December 2006, totalling HK\$484,009,000.

FIVE YEAR FINANCIAL SUMMARY

A summary of the results and of the assets and liabilities of the Group for the last five financial years is set out on page 83 to 84.

RESERVES

Movements in the reserves of the Group during the year are set out in the consolidated statement of changes in equity on page 31.

PROPERTY, PLANT AND EQUIPMENT

Details of the movements in property, plant and equipment of the Group are set out in note 14 to the consolidated financial statements.

SHARE CAPITAL

Details of the movements during the year in share capital of the Company are set out in note 29 to the consolidated financial statements.

DISTRIBUTABLE RESERVES OF THE COMPANY

The Company's reserves available for distribution to shareholders as at 31 December 2006 were as follows:

	HK\$'000
Contributed surplus	133,795
Retained profits	3,388,689
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	3,522,484
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Under the Companies Act 1981 of Bermuda (as amended), the contributed surplus account of the Company is available for distribution. However, the Company cannot declare or pay a dividend, or make a distribution out of contributed surplus if:

- (a) it is, or would after the payment be, unable to pay its liabilities as they become due; or
- (b) the realisable value of its assets would thereby be less than the aggregate of its liabilities and its issued share capital and share premium accounts.

PRE-EMPTIVE RIGHTS

There are no provisions for pre-emptive rights under the Company's Bye-laws or the laws of Bermuda that would oblige the Company to offer new shares on a pro-rata basis to existing shareholders.

PURCHASE, SALE OR REDEMPTION OF THE COMPANY'S LISTED SECURITIES

Neither the Company nor any of its subsidiaries has purchased or sold any of the Company's listed securities during the year.

DIRECTORS

The directors of the Company during the year and up to the date of this report were:

Executive Directors:

Mr Li Hualin
Mr Zhang Bowen (appointed on 5 January 2007)
Mr Wang Mingcai
Mr Cheng Cheng

Non-Executive Director:

Mr Lin Jingao (resigned on 25 June 2006)

Independent Non-Executive Directors:

Dr Lau Wah Sum
Mr Li Kwok Sing Aubrey
Dr Liu Xiao Feng

In accordance with Article 89 and 97 of the Company's Bye-Laws, Mr Zhang Bowen, Mr Wang Mingcai and Dr Liu Xiao Feng shall retire at the forthcoming annual general meeting and, being eligible, offer themselves for re-election.

None of the directors has a service contract with the Company which is not determinable by the Company within one year without payment of compensation, other than statutory compensation.

Independent Non-Executive Directors, Mr Li Kwok Sing Aubrey and Dr Liu Xiao Feng, were appointed for a two-year term expiring on 31 July 2008 and 15 April 2008 respectively, while Dr Lau Wah Sum was appointed and will retire at 2008 general annual meeting pursuant to Company's Bye-laws.

BRIEF BIOGRAPHICAL DETAILS IN RESPECT OF DIRECTORS AND SENIOR MANAGEMENT

Directors

Mr Li Hualin (*Chairman*)

Age 44, after graduated from South West Petroleum University in 1983 with Bachelor's Degree in Oil and Gas Exploration and Prospecting Engineering, Mr Li joined China National Petroleum Corporation ("CNPC") in the same year. He was the Deputy Director of CNPC office at Houston in the U.S.A.; Chairman & General Manager of CNPC Canada Ltd in Canada and Deputy General Manager of China National Oil and Gas Exploration and Development Corporation. In 2000, Mr Li was awarded the degree of Master of Business Administration from The University of Nebraska. He joined the Company as Executive Vice-Chairman & Managing Director in January 2001 and become the Chief Executive Officer in 2005. Mr Li was re-designated as the Chairman of the Company in January 2007

Mr Zhang Bowen (*Chief Executive Officer*)

Aged 40, joined the Company on 1 January 2007. He holds a Bachelor degree from Xian Electronic Scientific University in computer science and a Master degree in petroleum geology from Daqing Petroleum University. Since he graduated, Mr. Zhang joined China National Oil and Gas Exploration and Development Corporation, a subsidiary of CNPC. He has over 10 years of working experience in the oil and gas industry. Immediately before he joined the Company, he was the executive vice president of CNPC America Limited.

Mr Wang Mingcai (*Executive Director*)

Age 61, graduated from Petroleum University of Beijing in 1970 with Bachelor's Degree in Petroleum Geology and was awarded the Certificate of Mastery in English from Zhongshan University in 1987. Mr Wang has more than 30 years' experience in the petroleum industry. He has worked at Liaohe Oil Field as Engineer and Project Manager; Senior Engineer and Project Manager of China Offshore Oil Nanhai East Corp and Senior Oil Reservoir Engineer of the ACT (with Agip, Chevron and Texaco) Operation group. From 1993, Mr Wang has been assigned to be responsible for CNPC overseas projects. He was the President of CNPC International Venezuela Ltd. Mr Wang joined the Company as Executive Chairman since 2001 and re-designated as Executive Director in January 2007.

Mr Cheng Cheng (*Executive Director*)

Age 38, was appointed as an Executive Director in June 2004. He is currently a Deputy General Manager of the Company. Before joining the Company, Mr Cheng has over 15 years industry experience working at various departments and sections of China National Petroleum Corporation including 3 years in Canada as Vice President of CNPC International (Canada) Limited. Mr Cheng has a Master of Business Administration from the University of Calgary, Canada, a Master in Energy and Environment Economy from Scuola Superiore Enrico Mattei, Milan Italy and Diploma in Petroleum Technical Economy from Jiangnan Institute of Petroleum, the PRC.

BRIEF BIOGRAPHICAL DETAILS IN RESPECT OF DIRECTORS AND SENIOR MANAGEMENT (continued)**Directors (continued)****Dr Lau Wah Sum**, GBS, LLD, DBA, JP (*Independent Non-Executive Director*)

Age 79, is a Fellow of the Chartered Institute of Management Accountants. He was the Chairman of Urban Renewal Authority. He is currently the President of W S Lau & Associates Limited and Chairman of Equity Holdings Limited. He serves the community as Court Member of the University of Science and Technology of Hong Kong. He also sits on the Board of several listed companies in Hong Kong. He joined the Company as an Independent Non-Executive Director in August 1994.

Mr Li Kwok Sing Aubrey (*Independent Non-Executive Director*)

Age 57, was appointed as an Independent Non-Executive Director of the Company in 1998. He is a director of Management Capital Limited, a financial advisory and direct investment firm, and has over 30 years' experience in merchant banking and commercial banking. He is also a non-executive director of ABC Communications (Holdings) Limited, The Bank of East Asia, Limited, Cafe de Coral Holdings Limited, China Everbright International Limited, Kowloon Development Company Limited and Pokfulam Development Company Limited and had been a non-executive director of Value Partners China Greenchip Fund Limited up to 26 March 2007. He is non-executive chairman of Atlantis Asian Recovery Fund plc. Mr Li has a Master of Business Administration from Columbia University and a Bachelor of Science in Civil Engineering from Brown University.

Dr Liu Xiao Feng (*Independent Non-Executive Director*)

Age 44, was appointed as an Independent Non-Executive Director of the Company in April 2004. He has worked with various international financial institutions, and has over 13 years' experience in corporate finance. Mr Liu has a Ph.D and Master degrees from the Faculty of Economics, University of Cambridge and a Bachelor of Economics from Sichuan Institute of Finance and Economics, China.

Senior Management**Mr Lau Hak Woon** (*General Manager – Finance and Company Secretary*)

Age 54, member of Hong Kong Institute of Certified Public Accountants in Hong Kong; fellow member of The Chartered Association of Certified Accountants in UK and Certified Management Accountant of the Society of Management Accountants of Ontario in Canada. Mr Lau has a Master of Business Administration from Newport University and more than 30 years' experience in accounting and financial management. He joined the Company in 1997. Before joining the Company, he was the Chief Financial Officer of several large companies in Hong Kong and Canada.

DIRECTORS' INTERESTS IN CONTRACTS

No contracts of significance in relation to the Group's business to which the Company, any of its fellow subsidiaries or its parent company was a party and in which a director of the Company had a material interest, whether directly or indirectly, subsisted at the end of the year or at any time during the year.

REPORT OF THE DIRECTORS

DIRECTORS' INTERESTS IN SHARES

At 31 December 2006, the interests of the directors of the Company in the shares and its associated corporations (within the meaning of the Securities and Future Ordinance (the "SFO")), as recorded in the register required to be kept by the Company under section 352 of Part XV of the SFO or as otherwise notified to the Company and The Stock Exchange of Hong Kong Limited pursuant to the Model Code for Securities Transactions by Directors of Listed Companies, were as follows:

Share options are granted to directors and chief executives under the executive share option scheme approved by the board of directors on 23 October 1991 and 3 June 2002. Details are set out in the section headed "Share Options" of this report.

Save as disclosed above, at no time during the year was the Company or any of, its subsidiaries, its fellow subsidiaries and its holding company a party to any arrangement to enable the directors and chief executives of the Company (including their spouses and children under 18 years of age) to hold any interests or short positions in the shares or underlying shares in, or debentures of, the Company or its associated corporations.

SHARE OPTIONS

Particulars of the share option schemes of the Company are set out in note 30 to the consolidated financial statements.

The following table discloses the movements during the year in the number of share options of the Company which have been granted to the directors and employees of the Company:

				Number of share options		
Name of director	Date of grant	Exercisable period	Exercise price HK\$	Outstanding	Exercised	Outstanding
				at 1 Jan 2006	during the year	at 31 Dec 2006
Directors:						
Mr Wang Mingcai	27 Apr 2005	27 Jul 2005 to 26 Apr 2010	1.224	25,000,000	–	25,000,000
Mr Li Hualin	27 Apr 2005	27 Jul 2005 to 26 Apr 2010	1.224	20,000,000	–	20,000,000
Mr Cheng Cheng	25 Jun 2004	25 Sept 2004 to 24 Jun 2009	0.940	20,000,000	–	20,000,000
Mr Lin Jingao	26 Apr 2001	26 Jul 2001 to 25 Apr 2006	0.610	10,000,000	(10,000,000)	–
Dr Lau Wah Sum	8 Jan 2004	8 Apr 2004 to 7 Jan 2009	1.362	3,500,000	–	3,500,000
Mr Li Kwok Sing Aubrey	8 Jan 2004	8 Apr 2004 to 7 Jan 2009	1.362	3,500,000	–	3,500,000
Dr Liu Xiao Feng	27 Apr 2005	27 Jul 2005 to 26 Apr 2010	1.224	3,500,000	(1,000,000)	2,500,000
Employee:	25 Jun 2004	25 Sept 2004 to 24 Jun 2009	0.940	5,000,000	(5,000,000)	–
	27 Apr 2005	27 Jul 2005 to 26 Apr 2010	1.224	5,000,000	–	5,000,000
				95,500,000	(16,000,000)	79,500,000

Note: The weighted average closing price of the Company's shares immediately before the dates on which the share options were exercised was HK\$4.36.

SUBSTANTIAL SHAREHOLDERS INTEREST IN SHARES

At 31 December 2006, the register of substantial shareholders required to be kept under section 336 of Part XV of the SFO shows that the following substantial shareholders' interests, being 5% or more of the Company's issued share capital.

Name of shareholder		Number of shares	Approximate percentage of issued share capital
Sun World Limited	Long position	2,549,317,342 ¹	52.67%
JP Morgan Chase & Co. ²	Long position	530,347,228	10.96%
	Lending pool	82,207,228	1.70%

¹ All shares are registered under the name of HKSCC Nominees Limited.

² JP Morgan Chase & Co. through its various controlled corporation is interested in aggregate 530,347,228 (long position) and 82,207,228 (lending pools) share of the company.

Sun World Limited ("Sun World") is a wholly-owned subsidiary of CNPC and CNPC is accordingly deemed to have interest in the 2,549,317,342 shares held by Sun World.

Save as disclosed above, as at 31 December 2006, the directors and the chief executive of the Company are not aware of any person (other than a director or chief executive of the Company) who had any interest or short position in the shares or underlying shares of the Company which would fall to be disclosed to the Company under the provisions of Part XV of the SFO, or who was, directly or indirectly, interested in 5% or more of the nominal value of any class of share capital carrying rights to vote in all circumstances at general meetings of the Company.

CONVERTIBLE SECURITIES, OPTIONS, WARRANTS OR SIMILAR RIGHTS

Other than share options as set out in note 30 to the consolidated financial statements, the Company had no outstanding convertible securities, options, warrants or other similar rights as at 31 December 2006 and there had been no exercise of convertible securities, options, warrants or similar rights during the year.

CONNECTED TRANSACTIONS

Certain related party transactions as disclosed in note 38 to the consolidated financial statements constituted connected transactions under Listing Rules, required to be disclosed in accordance with Chapter 14A of the Listing Rules. The Independent Non-Executive Directors, Dr Lau Wah Sum, Mr Li Kwok Sing Aubrey and Dr Liu Xiao Feng, have reviewed the transactions disclosed in note 38 to the consolidated financial statements, and confirmed that these transactions were entered into in the ordinary and usual course of business, on normal commercial terms and are fair and reasonable in the interests of shareholders of the Company as a whole.

Pursuant to Rule 14A.38 of the Rules Governing the Listing Securities on The Stock Exchange of Hong Kong Limited, the board of directors engaged the auditors of the Company to perform certain agreed upon procedures in respect of the continuing connected transactions of the Group. The auditors have reported their factual findings on these procedures to the board of directors. The independent non-executive directors have reviewed the continuing connected transactions and the report of the auditors and have confirmed that the transactions have been entered into by the Company in the ordinary course of its business, on normal commercial terms on terms no less favorable than terms available to or from independent third parties, and in accordance with the terms of the agreement governing such transactions that are fair and reasonable and in the interests of the shareholders of the Company as a whole.

REPORT OF THE DIRECTORS

26

MANAGEMENT CONTRACTS

The Group has entered into certain entrustment contracts in relation to the management of the oil production under the Xinjiang Contract and the Leng Jiapu Contract. Details of those contracts are set out in notes 34 and 35 to the consolidated financial statements.

MAJOR CUSTOMERS AND SUPPLIERS

The percentage of the Group's purchases and sales attributable to major suppliers and customers are as follows:

Percentage of purchases attributable to the Group's largest supplier	34.96%
Percentage of purchases attributable to the Group's five largest suppliers	64.97%
Percentage of sales attributable to the Group's largest customer	69.68%
Percentage of sales attributable to the Group's five largest customers	100%

Xinjiang Petroleum Exploration Bureau, an operational entity owned and controlled by CNPC, is the Group's largest supplier.

PetroChina Company Limited, a listed subsidiary of CNPC, is the Group's largest customer.

Save for the above, none of the directors, their associates or any shareholder (which to the knowledge of the directors owns more than 5% of the Company's share capital) has an interest in the major suppliers or customers noted above.

DONATIONS

During the year, the Group made charitable and other donations amounting to HK\$10,000 (2005: HK\$10,000).

SUFFICIENCY OF PUBLIC FLOAT

Based on the information that is publicly available to the knowledge of the directors, it is confirmed that there is sufficient public float of more than 25% of the Company's issued shares at the date of this annual report.

AUDITOR

During the year, Messrs. PricewaterhouseCoopers, who acted as auditor of the Company for the past three years, retired and Messrs. Deloitte Touche Tohmatsu were appointed as auditor of the Company.

A resolution will be submitted to the forthcoming annual general meeting of the Company to re-appoint Messrs. Deloitte Touche Tohmatsu as auditor of the Company.

On behalf of the Board

Li Hualin

Chairman

Hong Kong, 11 April 2007