MORGAN STANLEY
Form 424B2
April 29, 2019

CALCULATION OF REGISTRATION FEE

Title of Each Class of Securities Offered	*Maximum Aggregate Offering Price*	*Amount of Registration Fee*
Buffered Performance Leveraged Upside Securities due 2021	$1,037,000	$125.68

April 2019

Pricing Supplement No. 1,755

Registration Statement Nos. 333-221595; 333-221595-01

Dated April 25, 2019

Filed pursuant to Rule 424(b)(2)

Morgan Stanley Finance LLC

Structured Investments

Opportunities in U.S. Equities

Buffered PLUS Based on the Value of the S&P 500® Index due April 29, 2021

Buffered Performance Leveraged Upside Securities℠

Fully and Unconditionally Guaranteed by Morgan Stanley

Principal at Risk Securities

The Buffered PLUS are unsecured obligations of Morgan Stanley Finance LLC ("MSFL") and are fully and unconditionally guaranteed by Morgan Stanley. The Buffered PLUS will pay no interest, provide a minimum payment at maturity of only 15% of the stated principal amount and have the terms described in the accompanying product supplement for PLUS, index supplement and prospectus, as supplemented or modified by this document. At maturity, if the underlying index has **appreciated** in value, investors will receive the stated principal amount of their investment plus leveraged upside performance of the underlying index, subject to the maximum payment at maturity. If the underlying index has **depreciated** in value, but the underlying index has not declined by more than the specified buffer amount, the Buffered PLUS will redeem for par. However, if the underlying index has declined by more than the buffer amount, investors will lose 1% for every 1% decline beyond the specified buffer amount, subject to the minimum payment at maturity of 15% of the stated principal amount. Investors may lose up to 85% of the stated principal amount of the Buffered PLUS. The Buffered PLUS are for investors who seek an equity index-based return and who are willing to risk their principal and forgo current income and upside above the maximum payment at maturity in exchange for the leverage and buffer features that in each case apply to a limited range of performance of the underlying index. The Buffered PLUS are notes issued as part of MSFL's Series A Global Medium-Term Notes program.

All payments are subject to our credit risk. If we default on our obligations, you could lose some or all of your investment. These Buffered PLUS are not secured obligations and you will not have any security interest in, or otherwise have any access to, any underlying reference asset or assets.

FINAL Terms

Issuer:	Morgan Stanley Finance LLC
Guarantor:	Morgan Stanley
Maturity date:	April 29, 2021
Underlying index:	S&P 500® Index
Aggregate principal amount:	$1,037,000
Payment at maturity per Buffered PLUS:	If the final index value is greater than the initial index value: $1,000 + leveraged upside payment *In no event will the payment at maturity exceed the maximum payment at maturity* If the final index value is less than or equal to the initial index value but has decreased from the initial index value by an amount less than or equal to the buffer amount of 15%: $1,000 If the final index value is less than the initial index value and has decreased from the initial index value by an amount greater than the buffer amount of 15%: ($1,000 x the index performance factor) + $150 *Under these circumstances, the payment at maturity will be less than the stated principal amount of $1,000. However, under no circumstances will the Buffered PLUS pay less than $150 per Buffered PLUS at maturity.*
Leveraged upside payment:	$1,000 × leverage factor × index percent increase
Index percent increase:	(final index value – initial index value) / initial index value
Initial index value:	2,926.17, which is the index closing value on the pricing date
Final index value:	The index closing value on the valuation date
Valuation date:	April 26, 2021, subject to postponement for non-index business days and certain market disruption events

Leverage factor:	200%
Buffer amount:	15%. As a result of the buffer amount of 15%, the value at or above which the underlying index must close on the valuation date so that investors do not suffer a loss on their initial investment in the Buffered PLUS is 2,487.245, which is approximately 85% of the initial index value.
Minimum payment at maturity:	$150 per Buffered PLUS (15% of the stated principal amount)
Index performance factor:	Final index value *divided* by the initial index value
Maximum payment at maturity:	$1,130 per Buffered PLUS (113% of the stated principal amount)
Stated principal amount:	$1,000 per Buffered PLUS
Issue price:	$1,000 per Buffered PLUS (see "Commissions and issue price" below)
Pricing date:	April 25, 2019
Original issue date:	April 30, 2019 (3 business days after the pricing date)
CUSIP:	61768D3U7
ISIN:	US61768D3U79
Listing:	The Buffered PLUS will not be listed on any securities exchange.
Agent:	Morgan Stanley & Co. LLC ("MS & Co."), an affiliate of MSFL and a wholly owned subsidiary of Morgan Stanley. See "Supplemental information regarding plan of distribution; conflicts of interest."
Estimated value on the pricing date:	$973.50 per Buffered PLUS. See "Investment Summary" beginning on page 2.

Commissions and issue price:	Price to public	Agent's commissions[1]	Proceeds to us[2]
Per Buffered PLUS	$1,000	$20	$980
Total	$1,037,000	$20,740	$1,016,260

(1) Selected dealers and their financial advisors will collectively receive from the agent, MS & Co., a fixed sales commission of $20 for each Buffered PLUS they sell. See "Supplemental information regarding plan of distribution; conflicts of interest." For additional information, see "Plan of Distribution (Conflicts of Interest)" in the accompanying product supplement for PLUS.

(2) See "Use of proceeds and hedging" on page 12.

The Buffered PLUS involve risks not associated with an investment in ordinary debt securities. See "Risk Factors" beginning on page 5.

The Securities and Exchange Commission and state securities regulators have not approved or disapproved these securities, or determined if this document or the accompanying product supplement, index supplement and prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The Buffered PLUS are not deposits or savings accounts and are not insured by the Federal Deposit Insurance Corporation or any other governmental agency or instrumentality, nor are they obligations of, or guaranteed by, a bank.

You should read this document together with the related product supplement, index supplement and prospectus, each of which can be accessed via the hyperlinks below. Please also see "Additional Terms of the Buffered PLUS" and "Additional Information About the Buffered PLUS" at the end of this document.

As used in this document, “we,” “us” and “our” refer to Morgan Stanley or MSFL, or Morgan Stanley and MSFL collectively, as the context requires.

Product Supplement for PLUS dated November 16, 2017 **Index Supplement dated November 16, 2017**

Prospectus dated November 16, 2017

Morgan Stanley Finance LLC

Buffered PLUS Based on the Value of the S&P 500® Index due April 29, 2021

Buffered Performance Leveraged Upside Securities℠

Principal at Risk Securities

Investment Summary

Buffered Performance Leveraged Upside Securities

Principal at Risk Securities

The Buffered PLUS Based on the Value of the S&P 500® Index due April 29, 2021 (the "Buffered PLUS") can be used:

§ As an alternative to direct exposure to the underlying index that enhances returns for a certain range of positive performance of the underlying index, subject to the maximum payment at maturity

§ To enhance returns and potentially outperform the underlying index in a moderately bullish scenario

§ To achieve similar levels of upside exposure to the underlying index as a direct investment, subject to the maximum payment at maturity, while using fewer dollars by taking advantage of the leverage factor

§ To obtain a buffer against a specified level of negative performance in the underlying index

Maturity:	Approximately 2 years
Leverage factor:	200%
Maximum payment at maturity:	$1,130 per Buffered PLUS (113% of the stated principal amount)
Buffer amount:	15%, with 1-to-1 downside exposure below the buffer
Minimum payment at maturity:	$150 per Buffered PLUS (15% of the stated principal amount). Investors may lose up to 85% of the stated principal amount of the Buffered PLUS.
Coupon:	None

The original issue price of each Buffered PLUS is $1,000. This price includes costs associated with issuing, selling, structuring and hedging the Buffered PLUS, which are borne by you, and, consequently, the estimated value of the

Buffered PLUS on the pricing date is less than $1,000. We estimate that the value of each Buffered PLUS on the pricing date is $973.50.

What goes into the estimated value on the pricing date?

In valuing the Buffered PLUS on the pricing date, we take into account that the Buffered PLUS comprise both a debt component and a performance-based component linked to the underlying index. The estimated value of the Buffered PLUS is determined using our own pricing and valuation models, market inputs and assumptions relating to the underlying index, instruments based on the underlying index, volatility and other factors including current and expected interest rates, as well as an interest rate related to our secondary market credit spread, which is the implied interest rate at which our conventional fixed rate debt trades in the secondary market.

What determines the economic terms of the Buffered PLUS?

In determining the economic terms of the Buffered PLUS, including the leverage factor, the maximum payment at maturity, the buffer amount and the minimum payment at maturity, we use an internal funding rate, which is likely to be lower than our secondary market credit spreads and therefore advantageous to us. If the issuing, selling, structuring and hedging costs borne by you were lower or if the internal funding rate were higher, one or more of the economic terms of the Buffered PLUS would be more favorable to you.

What is the relationship between the estimated value on the pricing date and the secondary market price of the Buffered PLUS?

The price at which MS & Co. purchases the Buffered PLUS in the secondary market, absent changes in market conditions, including those related to the underlying index, may vary from, and be lower than, the estimated value on the pricing date, because the secondary market price takes into account our secondary market credit spread as well as the bid-offer spread that MS & Co. would charge in a secondary market transaction of this type and other factors. However, because the costs associated with issuing, selling, structuring and hedging the Buffered PLUS are not fully deducted upon issuance, for a period of up to 6 months following the issue date, to the extent that MS & Co. may buy or sell the Buffered PLUS in the secondary market, absent changes in market conditions, including those related to the underlying index, and to our secondary market credit spreads, it would do so based on values higher than the estimated value. We expect that those higher values will also be reflected in your brokerage account statements.

MS & Co. may, but is not obligated to, make a market in the Buffered PLUS, and, if it once chooses to make a market, may cease doing so at any time.

April 2019 Page 2

Morgan Stanley Finance LLC

Buffered PLUS Based on the Value of the S&P 500® Index due April 29, 2021

Buffered Performance Leveraged Upside Securities℠

Principal at Risk Securities

Key Investment Rationale

The Buffered PLUS offer leveraged upside exposure to the underlying index, subject to the maximum payment at maturity, while providing limited protection against negative performance of the underlying index. Once the underlying index has decreased in value by more than the specified buffer amount, investors are exposed to the negative performance of the underlying index, subject to the minimum payment at maturity. At maturity, if the underlying index has appreciated, investors will receive the stated principal amount of their investment plus leveraged upside performance of the underlying index, subject to the maximum payment at maturity. At maturity, if the underlying index has depreciated and (i) if the final index value of the underlying index has not declined from the initial index value by more than the specified buffer amount, the Buffered PLUS will redeem for par, or (ii) if the final index value of the underlying index has declined by more than the buffer amount, the investor will lose 1% for every 1% decline beyond the specified buffer amount, subject to the minimum payment at maturity. **Investors may lose up to 85% of the stated principal amount of the Buffered PLUS.**

Leveraged Performance	The Buffered PLUS offer investors an opportunity to capture enhanced returns for a certain range of positive performance relative to a direct investment in the underlying index.
Upside Scenario	The underlying index increases in value, and, at maturity, the Buffered PLUS redeem for the stated principal amount of $1,000 plus 200% of the index percent increase, subject to the maximum payment at maturity of $1,130 per Buffered PLUS (113% of the stated principal amount).
Par Scenario	The underlying index declines in value by no more than 15%, and, at maturity, the Buffered PLUS redeem for the stated principal amount of $1,000.
Downside Scenario	The underlying index declines in value by more than 15%, and, at maturity, the Buffered PLUS redeem for less than the stated principal amount by an amount that is proportionate to the percentage decrease of the underlying index from the initial index value, plus the buffer amount of 15%. (Example: if the underlying index decreases in value by 35%, the Buffered PLUS will redeem for $800.00, or 80.00% of the stated principal amount.) The minimum payment at maturity is $150 per Buffered PLUS.

Morgan Stanley Finance LLC

Buffered PLUS Based on the Value of the S&P 500® Index due April 29, 2021

Buffered Performance Leveraged Upside Securities℠

Principal at Risk Securities

How the Buffered PLUS Work

Payoff Diagram

The payoff diagram below illustrates the payment at maturity on the Buffered PLUS based on the following terms:

Stated principal amount:	$1,000 per Buffered PLUS
Leverage factor:	200%
Buffer amount:	15%
Maximum payment at maturity:	$1,130 per Buffered PLUS (113.00% of the stated principal amount)
Minimum payment at maturity:	$150 per Buffered PLUS

Buffered PLUS Payoff Diagram

How it works

§ **Upside Scenario.** If the final index value is greater than the initial index value, investors will receive the $1,000 stated principal amount *plus* 200% of the appreciation of the underlying index over the term of the Buffered PLUS, subject to the maximum payment at maturity. Under the terms of the Buffered PLUS, an investor will realize the maximum payment at maturity of $1,130 per Buffered PLUS (113.00% of the stated principal amount) at a final index value of 106.50% of the initial index value.

§ If the underlying index appreciates 2%, the investor would receive a 4% return, or $1,040.00 per Buffered PLUS.

§ If the underlying index appreciates 40%, the investor would receive only the maximum payment at maturity of $1,130 per Buffered PLUS, or 113.00% of the stated principal amount.

§ **Par Scenario.** If the final index value is less than or equal to the initial index value but has decreased from the initial index value by an amount less than or equal to the buffer amount of 15%, investors will receive the stated principal amount of $1,000 per Buffered PLUS.

§ If the underlying index depreciates 5%, investors will receive the $1,000 stated principal amount.

§ **Downside Scenario.** If the final index value is less than the initial index value and has decreased from the initial index value by an amount greater than the buffer amount of 15%, investors will receive an amount that is less than the stated principal amount by an amount that is proportionate to the percentage decrease of the value of the underlying index from the initial index value, plus the buffer amount of 15%. The minimum payment at maturity is $150 per Buffered PLUS.

§ For example, if the underlying index depreciates 45%, investors would lose 30.00% of their principal and receive only $700 per Buffered PLUS at maturity, or 70.00% of the stated principal amount.

Morgan Stanley Finance LLC

Buffered PLUS Based on the Value of the S&P 500® Index due April 29, 2021

Buffered Performance Leveraged Upside Securities℠

Principal at Risk Securities

Risk Factors

The following is a non-exhaustive list of certain key risk factors for investors in the Buffered PLUS. For further discussion of these and other risks, you should read the section entitled "Risk Factors" in the accompanying product supplement for PLUS, index supplement and prospectus. We also urge you to consult your investment, legal, tax, accounting and other advisers in connection with your investment in the Buffered PLUS.

§ **Buffered PLUS do not pay interest and provide a minimum payment at maturity of only 15% of your principal.** The terms of the Buffered PLUS differ from those of ordinary debt securities in that the Buffered PLUS do not pay interest, and provide a minimum payment at maturity of only 15% of the stated principal amount of the Buffered PLUS, subject to our credit risk. If the final index value is less than 85% of the initial index value, you will receive for each Buffered PLUS that you hold a payment at maturity that is less than the stated principal amount of each Buffered PLUS by an amount proportionate to the decline in the closing value of the underlying index from the initial index value, plus $150 per Buffered PLUS. **Accordingly, investors may lose up to 85% of the stated principal amount of the Buffered PLUS.**

§ **The appreciation potential of the Buffered PLUS is limited by the maximum payment at maturity.** The appreciation potential of the Buffered PLUS is limited by the maximum payment at maturity of $1,130 per Buffered PLUS, or 113% of the stated principal amount. Although the leverage factor provides 200% exposure to any increase in the final index value over the initial index value, because the payment at maturity will be limited to 113% of the stated principal amount for the Buffered PLUS, any increase in the final index value over the initial index value by more than 6.50% of the initial index value will not further increase the return on the Buffered PLUS.

§ **The market price of the Buffered PLUS will be influenced by many unpredictable factors.** Several factors, many of which are beyond our control, will influence the value of the Buffered PLUS in the secondary market and the price at which MS & Co. may be willing to purchase or sell the Buffered PLUS in the secondary market, including the value, volatility (frequency and magnitude of changes in value) and dividend yield of the underlying index, interest and yield rates in the market, time remaining until the Buffered PLUS mature, geopolitical conditions and economic, financial, political, regulatory or judicial events that affect the underlying index or equities markets generally and which may affect the final index value of the underlying index and any actual or anticipated changes in our credit ratings or credit spreads. The value of the underlying index may be, and has recently been, volatile, and we can give you no assurance that the volatility will lessen. See "S&P 500® Index Overview" below. You may receive less, and possibly significantly less, than the stated principal amount per Buffered PLUS if you try to sell your Buffered PLUS prior to maturity.

§ **The Buffered PLUS are subject to our credit risk, and any actual or anticipated changes to our credit ratings or credit spreads may adversely affect the market value of the Buffered PLUS.** You are dependent on our ability to pay all amounts due on the Buffered PLUS at maturity and therefore you are subject to our credit risk. If we default on our obligations under the Buffered PLUS, your investment would be at risk and you could lose some or all of your investment. As a result, the market value of the Buffered PLUS prior to maturity will be affected by changes in the market's view of our creditworthiness. Any actual or anticipated decline in our credit ratings or increase in the credit spreads charged by the market for taking our credit risk is likely to adversely affect the market value of the Buffered PLUS.

§ **As a finance subsidiary, MSFL has no independent operations and will have no independent assets.** As a finance subsidiary, MSFL has no independent operations beyond the issuance and administration of its securities and will have no independent assets available for distributions to holders of MSFL securities if they make claims in respect of such securities in a bankruptcy, resolution or similar proceeding. Accordingly, any recoveries by such holders will be limited to those available under the related guarantee by Morgan Stanley and that guarantee will rank *pari passu* with all other unsecured, unsubordinated obligations of Morgan Stanley. Holders will have recourse only to a single claim against Morgan Stanley and its assets under the guarantee. Holders of securities issued by MSFL should accordingly assume that in any such proceedings they would not have any priority over and should be treated *pari passu* with the claims of other unsecured, unsubordinated creditors of Morgan Stanley, including holders of Morgan Stanley-issued securities.

§ **The amount payable on the Buffered PLUS is not linked to the value of the underlying index at any time other than the valuation date.** The final index value will be based on the index closing value on the valuation date, subject to postponement for non-index business days and certain market disruption events. Even if the value of the underlying index appreciates prior to the valuation date but then drops by the valuation date by more than 15% of the initial index value, the payment at maturity will be less, and may be significantly less, than it would have been had the payment at maturity been linked to the value of the underlying index prior to such drop. Although the actual value of the underlying index on the stated maturity date or at other times during the term of the Buffered PLUS may be higher than the index closing value on the valuation date, the payment at maturity will be based solely on the index closing value on the valuation date.

Morgan Stanley Finance LLC

Buffered PLUS Based on the Value of the S&P 500® Index due April 29, 2021

Buffered Performance Leveraged Upside Securities℠

Principal at Risk Securities

§ **Investing in the Buffered PLUS is not equivalent to investing in the underlying index.** Investing in the Buffered PLUS is not equivalent to investing in the underlying index or its component stocks. As an investor in the Buffered PLUS, you will not have voting rights or rights to receive dividends or other distributions or any other rights with respect to stocks that constitute the underlying index.

§ **The rate we are willing to pay for securities of this type, maturity and issuance size is likely to be lower than the rate implied by our secondary market credit spreads and advantageous to us. Both the lower rate and the inclusion of costs associated with issuing, selling, structuring and hedging the Buffered PLUS in the original issue price reduce the economic terms of the Buffered PLUS, cause the estimated value of the Buffered PLUS to be less than the original issue price and will adversely affect secondary market prices.** Assuming no change in market conditions or any other relevant factors, the prices, if any, at which dealers, including MS & Co., may be willing to purchase the Buffered PLUS in secondary market transactions will likely be significantly lower than the original issue price, because secondary market prices will exclude the issuing, selling, structuring and hedging-related costs that are included in the original issue price and borne by you and because the secondary market prices will reflect our secondary market credit spreads and the bid-offer spread that any dealer would charge in a secondary market transaction of this type as well as other factors.

The inclusion of the costs of issuing, selling, structuring and hedging the Buffered PLUS in the original issue price and the lower rate we are willing to pay as issuer make the economic terms of the Buffered PLUS less favorable to you than they otherwise would be.

However, because the costs associated with issuing, selling, structuring and hedging the Buffered PLUS are not fully deducted upon issuance, for a period of up to 6 months following the issue date, to the extent that MS & Co. may buy or sell the Buffered PLUS in the secondary market, absent changes in market conditions, including those related to the underlying index, and to our secondary market credit spreads, it would do so based on values higher than the estimated value, and we expect that those higher values will also be reflected in your brokerage account statements.

§ **Adjustments to the underlying index could adversely affect the value of the Buffered PLUS.** The underlying index publisher may add, delete or substitute the stocks constituting the underlying index or make other methodological changes that could change the value of the underlying index. The underlying index publisher may discontinue or suspend calculation or publication of the underlying index at any time. In these circumstances, the calculation agent will have the sole discretion to substitute a successor index that is comparable to the discontinued underlying index and is not precluded from considering indices that are calculated and published by the calculation agent or any of its affiliates. If the calculation agent determines that there is no appropriate successor index, the payment at maturity on the Buffered PLUS will be an amount based on the closing prices at maturity of the securities composing the underlying index at the time of such discontinuance, without rebalancing or substitution, computed by the calculation agent in accordance with the formula for calculating the underlying index last in effect prior to discontinuance of the underlying index.

§ **The estimated value of the Buffered PLUS is determined by reference to our pricing and valuation models, which may differ from those of other dealers and is not a maximum or minimum secondary market price.** These pricing and valuation models are proprietary and rely in part on subjective views of certain market inputs and certain assumptions about future events, which may prove to be incorrect. As a result, because there is no market-standard way to value these types of securities, our models may yield a higher estimated value of the Buffered PLUS than those generated by others, including other dealers in the market, if they attempted to value the Buffered PLUS. In addition, the estimated value on the pricing date does not represent a minimum or maximum price at which dealers, including MS & Co., would be willing to purchase your Buffered PLUS in the secondary market (if any exists) at any time. The value of your Buffered PLUS at any time after the date of this document will vary based on many factors that cannot be predicted with accuracy, including our creditworthiness and changes in market conditions. See also "The market price of the Buffered PLUS will be influenced by many unpredictable factors" above.

§ **The Buffered PLUS will not be listed on any securities exchange and secondary trading may be limited.** The Buffered PLUS will not be listed on any securities exchange. Therefore, there may be little or no secondary market for the Buffered PLUS. MS & Co. may, but is not obligated to, make a market in the Buffered PLUS and, if it once chooses to make a market, may cease doing so at any time. When it does make a market, it will generally do so for transactions of routine secondary market size at prices based on its estimate of the current value of the Buffered PLUS, taking into account its bid/offer spread, our credit spreads, market volatility, the notional size of the proposed sale, the cost of unwinding any related hedging positions, the time remaining to maturity and the likelihood that it will be able to resell the Buffered PLUS. Even if there is a secondary market, it may not provide enough liquidity to allow you to trade or sell the Buffered PLUS easily. Since other broker-dealers may not participate significantly in the secondary market for the Buffered PLUS, the price at which you may be able to trade your Buffered PLUS is likely to depend on the price, if any, at which MS & Co. is willing to transact. If, at any time, MS & Co. were to cease making a market in the Buffered PLUS, it is likely that there would be no secondary market for the Buffered PLUS. Accordingly, you should be willing to hold your Buffered PLUS to maturity.

Morgan Stanley Finance LLC

Buffered PLUS Based on the Value of the S&P 500® Index due April 29, 2021

Buffered Performance Leveraged Upside Securities℠

Principal at Risk Securities

§ **The calculation agent, which is a subsidiary of Morgan Stanley and an affiliate of MSFL, will make determinations with respect to the Buffered PLUS.** As calculation agent, MS & Co. has determined the initial index value, will determine the final index value and will calculate the amount of cash you receive at maturity. Moreover, certain determinations made by MS & Co., in its capacity as calculation agent, may require it to exercise discretion and make subjective judgments, such as with respect to the occurrence or non-occurrence of market disruption events and the selection of a successor index or calculation of the final index value in the event of a market disruption event or discontinuance of the underlying index. These potentially subjective determinations may adversely affect the payout to you at maturity. For further information regarding these types of determinations, see "Description of PLUS—Postponement of Valuation Date(s)" and "—Calculation Agent and Calculations" and related definitions in the accompanying product supplement. In addition, MS & Co. has determined the estimated value of the Buffered PLUS on the pricing date.

§ **Hedging and trading activity by our affiliates could potentially adversely affect the value of the Buffered PLUS.** One or more of our affiliates and/or third-party dealers have carried out, and will continue to carry out, hedging activities related to the Buffered PLUS (and possibly to other instruments linked to the underlying index or its component stocks), including trading in the stocks that constitute the underlying index as well as in other instruments related to the underlying index. As a result, these entities may be unwinding or adjusting hedge positions during the term of the Buffered PLUS, and the hedging strategy may involve greater and more frequent dynamic adjustments to the hedge as the valuation date approaches. Some of our affiliates also trade the stocks that constitute the underlying index and other financial instruments related to the underlying index on a regular basis as part of their general broker-dealer and other businesses. Any of these hedging or trading activities on or prior to the pricing date could have increased the initial index value, and, therefore, could have increased the value at or above which the underlying index must close on the valuation date so that investors do not suffer a loss on their initial investment in the Buffered PLUS. Additionally, such hedging or trading activities during the term of the Buffered PLUS, including on the valuation date, could adversely affect the closing value of the underlying index on the valuation date, and, accordingly, the amount of cash an investor will receive at maturity.

§ **The U.S. federal income tax consequences of an investment in the Buffered PLUS are uncertain.** Please read the discussion under "Additional Information—Tax considerations" in this document and the discussion under "United States Federal Taxation" in the accompanying product supplement for PLUS (together, the "Tax Disclosure Sections") concerning the U.S. federal income tax consequences of an investment in the Buffered PLUS. If the Internal Revenue Service (the "IRS") were successful in asserting an alternative treatment, the timing and character of income on the Buffered PLUS might differ significantly from the tax treatment described in the Tax Disclosure Sections. For example, under one possible treatment, the IRS could seek to recharacterize the Buffered PLUS as debt instruments. In that event, U.S. Holders would be required to accrue into income original issue discount on the Buffered PLUS every year at a "comparable yield" determined at the time of issuance and recognize all income and gain in respect of the Buffered PLUS as ordinary income. Additionally, as discussed under "United States Federal Taxation—FATCA" in the accompanying product supplement for PLUS, the withholding rules commonly referred to as "FATCA" would apply to the Buffered PLUS if they were recharacterized as debt instruments. However, recently proposed regulations (the preamble to which specifies that taxpayers are permitted to rely on them pending finalization) eliminate the withholding requirement on payments of gross proceeds of a taxable disposition. The risk that financial instruments providing for buffers, triggers or similar downside protection features, such as the Buffered PLUS, would be recharacterized as debt is greater than the risk of recharacterization for comparable financial instruments that do not have such features. We do not plan to request a ruling from the IRS regarding the tax treatment of the Buffered PLUS, and the IRS or a court may not agree with the tax treatment described in the Tax Disclosure Sections.

In 2007, the U.S. Treasury Department and the IRS released a notice requesting comments on the U.S. federal income tax treatment of “prepaid forward contracts” and similar instruments. The notice focuses in particular on whether to require holders of these instruments to accrue income over the term of their investment. It also asks for comments on a number of related topics, including the character of income or loss with respect to these instruments; whether short-term instruments should be subject to any such accrual regime; the relevance of factors such as the exchange-traded status of the instruments and the nature of the underlying property to which the instruments are linked; the degree, if any, to which income (including any mandated accruals) realized by non-U.S. investors should be subject to withholding tax; and whether these instruments are or should be subject to the “constructive ownership” rule, which very generally can operate to recharacterize certain long-term capital gain as ordinary income and impose an interest charge. While the notice requests comments on appropriate transition rules and effective dates, any Treasury regulations or other guidance promulgated after consideration of these issues could materially and adversely affect the tax consequences of an investment in the Buffered PLUS, possibly with retroactive effect. Both U.S. and Non-U.S. Holders should consult their tax advisers regarding the U.S. federal income tax consequences of an investment in the Buffered PLUS, including possible alternative treatments, the issues presented by this notice and any tax consequences arising under the laws of any state, local or non-U.S. taxing jurisdiction.

Morgan Stanley Finance LLC

Buffered PLUS Based on the Value of the S&P 500® Index due April 29, 2021

Buffered Performance Leveraged Upside Securities℠

Principal at Risk Securities

S&P 500® Index Overview

The S&P 500® Index, which is calculated, maintained and published by S&P Dow Jones Indices LLC ("S&P"), consists of stocks of 500 component companies selected to provide a performance benchmark for the U.S. equity markets. The calculation of the S&P 500® Index is based on the relative value of the float adjusted aggregate market capitalization of the 500 component companies as of a particular time as compared to the aggregate average market capitalization of 500 similar companies during the base period of the years 1941 through 1943. For additional information about the S&P 500® Index, see the information set forth under "S&P 500® Index" in the accompanying index supplement.

Information as of market close on April 25, 2019:

Bloomberg Ticker Symbol:	SPX
Current Index Value:	2,926.17
52 Weeks Ago:	2,639.40
52 Week High (on 4/23/2019):	2,933.68
52 Week Low (on 12/24/2018):	2,351.10

The following graph sets forth the daily index closing values of the underlying index for each quarter in the period from January 1, 2014 through April 25, 2019. The related table sets forth the published high and low closing values, as well as end-of-quarter closing values, of the underlying index for each quarter in the same period. The index closing value of the underlying index on April 25, 2019 was 2,926.17. We obtained the information in the table and graph below from Bloomberg Financial Markets, without independent verification. The underlying index has at times experienced periods of high volatility. You should not take the historical values of the underlying index as an indication of its future performance, and no assurance can be given as to the index closing value of the underlying index on the valuation date.

S&P 500® Index Daily Index Closing Values

January 1, 2014 to April 25, 2019

Morgan Stanley Finance LLC

Buffered PLUS Based on the Value of the S&P 500® Index due April 29, 2021

Buffered Performance Leveraged Upside Securities℠

Principal at Risk Securities

S&P 500® Index	High	Low	Period End
2014			
First Quarter	1,878.04	1,741.89	1,872.34
Second Quarter	1,962.87	1,815.69	1,960.23
Third Quarter	2,011.36	1,909.57	1,972.29
Fourth Quarter	2,090.57	1,862.49	2,058.90
2015			
First Quarter	2,117.39	1,992.67	2,067.89
Second Quarter	2,130.82	2,057.64	2,063.11
Third Quarter	2,128.28	1,867.61	1,920.03
Fourth Quarter	2,109.79	1,923.82	2,043.94
2016			
First Quarter	2,063.95	1,829.08	2,059.74
Second Quarter	2,119.12	2,000.54	2,098.86
Third Quarter	2,190.15	2,088.55	2,168.27
Fourth Quarter	2,271.72	2,085.18	2,238.83
2017			
First Quarter	2,395.96	2,257.83	2,362.72
Second Quarter	2,453.46	2,328.95	2,423.41
Third Quarter	2,519.36	2,409.75	2,519.36
Fourth Quarter	2,690.16	2,529.12	2,673.61
2018			
First Quarter	2,872.87	2,581.00	2,640.87
Second Quarter	2,786.85	2,581.88	2,718.37
Third Quarter	2,930.75	2,713.22	2,913.98
Fourth Quarter	2,925.51	2,351.10	2,506.85
2019			
First Quarter	2,854.88	2,447.89	2,834.40
Second Quarter (through April 25, 2019)	2,933.68	2,867.19	2,926.17

"Standard & Poor's®," "S&P®," "S&P 500®," "Standard & Poor's 500" and "500" are trademarks of Standard and Poor's Financial Services LLC. See "S&P 500® Index" in the accompanying index supplement.

Morgan Stanley Finance LLC

Buffered PLUS Based on the Value of the S&P 500® Index due April 29, 2021

Buffered Performance Leveraged Upside Securities℠

Principal at Risk Securities

Additional Terms of the Buffered PLUS

Please read this information in conjunction with the summary terms on the front cover of this document.

Additional Terms:

If the terms described herein are inconsistent with those described in the accompanying product supplement, index supplement or prospectus, the terms described herein shall control.

Underlying index publisher:	S&P Dow Jones Indices LLC or any successor thereof
Interest:	None
Bull market or bear market PLUS:	Bull market PLUS
Postponement of maturity date:	If the scheduled valuation date is not an index business day or if a market disruption event occurs on that day so that the valuation date as postponed falls less than two business days prior to the scheduled maturity date, the maturity date of the Buffered PLUS will be postponed to the second business day following that valuation date as postponed.
Denominations:	$1,000 per Buffered PLUS and integral multiples thereof
Trustee:	The Bank of New York Mellon
Calculation agent:	MS & Co.
Issuer notice to registered security holders, the trustee and the depositary:	In the event that the maturity date is postponed due to postponement of the valuation date, the issuer shall give notice of such postponement and, once it has been determined, of the date to which the maturity date has been rescheduled (i) to each registered holder of the Buffered PLUS by mailing notice of such postponement by first class mail, postage prepaid, to such registered holder's last address as it shall appear upon the registry books, (ii) to the trustee by facsimile confirmed by mailing such notice to the trustee by first class mail, postage prepaid, at its New York office and (iii) to The Depository Trust Company (the "depositary") by telephone or facsimile, confirmed by mailing such notice to the depositary by first class mail, postage prepaid. Any notice that is mailed to a registered holder of the Buffered PLUS in the manner herein provided shall be conclusively presumed to have been duly given to such registered holder, whether or not such registered holder receives the notice. The issuer shall give such notice as promptly as possible, and in no case later than (i) with respect to notice of postponement of the maturity date, the business day immediately preceding the scheduled maturity date and (ii) with respect to notice of the date to which the maturity date has been rescheduled, the business day immediately following the actual valuation date for determining the final index value.

The issuer shall, or shall cause the calculation agent to, (i) provide written notice to the trustee and to the depositary of the amount of cash to be delivered with respect to each stated principal amount of the Buffered PLUS, on or prior to 10:30 a.m. (New York City time) on the business day preceding the maturity date, and (ii) deliver the aggregate cash amount due with respect to the Buffered PLUS to the trustee for delivery to the depositary, as holder of the Buffered PLUS, on the maturity date.

Morgan Stanley Finance LLC

Buffered PLUS Based on the Value of the S&P 500® Index due April 29, 2021

Buffered Performance Leveraged Upside Securities℠

Principal at Risk Securities

Additional Information About the Buffered PLUS

Additional Information:	
Minimum ticketing size:	$1,000 / 1 Buffered PLUS
Tax considerations:	Although there is uncertainty regarding the U.S. federal income tax consequences of an investment in the Buffered PLUS due to the lack of governing authority, in the opinion of our counsel, Davis Polk & Wardwell LLP, under current law, and based on current market conditions, a Buffered PLUS should be treated as a single financial contract that is an "open transaction" for U.S. federal income tax purposes.

Assuming this treatment of the Buffered PLUS is respected and subject to the discussion in "United States Federal Taxation" in the accompanying product supplement for PLUS, the following U.S. federal income tax consequences should result based on current law:

§ A U.S. Holder should not be required to recognize taxable income over the term of the Buffered PLUS prior to settlement, other than pursuant to a sale or exchange.

§ Upon sale, exchange or settlement of the Buffered PLUS, a U.S. Holder should recognize gain or loss equal to the difference between the amount realized and the U.S. Holder's tax basis in the Buffered PLUS. Such gain or loss should be long-term capital gain or loss if the investor has held the Buffered PLUS for more than one year, and short-term capital gain or loss otherwise.

In 2007, the U.S. Treasury Department and the Internal Revenue Service (the "IRS") released a notice requesting comments on the U.S. federal income tax treatment of "prepaid forward contracts" and similar instruments. The notice focuses in particular on whether to require holders of these instruments to accrue income over the term of their investment. It also asks for comments on a number of related topics, including the character of income or loss with respect to these instruments; whether short-term instruments should be subject to any such accrual regime; the relevance of factors such as the exchange-traded status of the instruments and the nature of the underlying property to which the instruments are linked; the degree, if any, to which income (including any mandated accruals) realized by non-U.S. investors should be subject to withholding tax; and whether these instruments are or should be subject to the "constructive ownership" rule, which very generally can operate to recharacterize certain long-term capital gain as ordinary income and impose an interest charge. While the notice requests comments on appropriate transition rules and effective dates, any Treasury regulations or other guidance promulgated after consideration of these issues could materially and adversely affect the tax consequences of an investment in the Buffered PLUS, possibly with retroactive effect.

As discussed in the accompanying product supplement for PLUS, Section 871(m) of the Internal Revenue Code of 1986, as amended, and Treasury regulations promulgated thereunder ("Section 871(m)") generally impose a 30% (or a lower applicable treaty rate) withholding tax on dividend equivalents paid or deemed paid to Non-U.S. Holders with respect to certain financial instruments linked to U.S. equities or indices that include U.S. equities (each, an "Underlying Security"). Subject to certain exceptions, Section 871(m) generally applies to securities that substantially replicate the economic performance of one or more Underlying Securities, as determined based on tests set forth in the applicable Treasury regulations (a "Specified Security"). However, pursuant to an IRS notice, Section 871(m) will not apply to securities issued before January 1, 2021 that do not have a delta of one with respect to any Underlying Security. Based on our determination that the Buffered PLUS do not have a delta of one with respect to any Underlying Security, our counsel is of the opinion that the Buffered PLUS should not be Specified Securities and, therefore, should not be subject to Section 871(m).

Our determination is not binding on the IRS, and the IRS may disagree with this determination. Section 871(m) is complex and its application may depend on your particular circumstances, including whether you enter into other transactions with respect to an Underlying Security. If withholding is required, we will not be required to pay any additional amounts with respect to the amounts so withheld. You should consult your tax adviser regarding the potential application of Section 871(m) to the Buffered PLUS.

Both U.S. and non-U.S. investors considering an investment in the Buffered PLUS should read the discussion under "Risk Factors" in this document and the discussion under "United States Federal Taxation" in the accompanying product supplement for PLUS and consult their tax advisers regarding all aspects of the U.S. federal income tax consequences of an investment in the Buffered PLUS, including possible alternative treatments, the issues presented by the aforementioned notice and any tax consequences arising under the laws of any state, local or non-U.S. taxing jurisdiction.

The discussion in the preceding paragraphs under "Tax considerations" and the discussion contained in the section entitled "United States Federal Taxation" in the accompanying product supplement for PLUS, insofar as they purport to describe provisions of U.S. federal income tax laws or legal conclusions with respect thereto, constitute the full opinion of Davis Polk & Wardwell LLP regarding the material U.S. federal tax consequences of an investment in the Buffered PLUS.

Morgan Stanley Finance LLC

Buffered PLUS Based on the Value of the S&P 500® Index due April 29, 2021

Buffered Performance Leveraged Upside Securities℠

Principal at Risk Securities

	The proceeds from the sale of the Buffered PLUS will be used by us for general corporate purposes. We will receive, in aggregate, $1,000 per Buffered PLUS issued, because, when we enter into hedging transactions in order to meet our obligations under the Buffered PLUS, our hedging counterparty will reimburse the cost of the agent's commissions. The costs of the Buffered PLUS borne by you and described beginning on page 2 above comprise the agent's commissions and the cost of issuing, structuring and hedging the Buffered PLUS.
Use of proceeds and hedging:	On or prior to the pricing date, we hedged our anticipated exposure in connection with the Buffered PLUS by entering into hedging transactions with our affiliates and/or third-party dealers. We expect our hedging counterparties to have taken positions in stocks of the underlying index and in futures and options contracts on the underlying index and any component stocks of the underlying index listed on major securities markets. Such purchase activity could have increased the value of the underlying index on the pricing date, and, therefore, could have increased the value at or above which the underlying index must close on the valuation date so that investors do not suffer a loss on their initial investment in the Buffered PLUS. In addition, through our affiliates, we are likely to modify our hedge position throughout the term of the Buffered PLUS, including on the valuation date, by purchasing and selling the stocks constituting the underlying index, futures or options contracts on the underlying index or its component stocks listed on major securities markets or positions in any other available securities or instruments that we may wish to use in connection with such hedging activities. As a result, these entities may be unwinding or adjusting hedge positions during the term of the Buffered PLUS, and the hedging strategy may involve greater and more frequent dynamic adjustments to the hedge as the valuation date approaches. We cannot give any assurance that our hedging activities will not affect the value of the underlying index, and, therefore, adversely affect the value of the Buffered PLUS or the payment you will receive at maturity. For further information on our use of proceeds and hedging, see "Use of Proceeds and Hedging" in the accompanying product supplement for PLUS.
Benefit plan investor considerations:	Each fiduciary of a pension, profit-sharing or other employee benefit plan subject to Title I of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") (a "Plan"), should consider the fiduciary standards of ERISA in the context of the Plan's particular circumstances before authorizing an investment in the Buffered PLUS. Accordingly, among other factors, the fiduciary should consider whether the investment would satisfy the prudence and diversification requirements of ERISA and would be consistent with the documents and instruments governing the Plan.
	In addition, we and certain of our affiliates, including MS & Co., may each be considered a "party in interest" within the meaning of ERISA, or a "disqualified person" within the meaning of the Internal Revenue Code of 1986, as amended (the "Code"), with respect to many Plans, as well as many individual retirement accounts and Keogh plans (such accounts and plans, together with other plans,

accounts and arrangements subject to Section 4975 of the Code, also "Plans"). ERISA Section 406 and Code Section 4975 generally prohibit transactions between Plans and parties in interest or disqualified persons. Prohibited transactions within the meaning of ERISA or the Code would likely arise, for example, if the Buffered PLUS are acquired by or with the assets of a Plan with respect to which MS & Co. or any of its affiliates is a service provider or other party in interest, unless the Buffered PLUS are acquired pursuant to an exemption from the "prohibited transaction" rules. A violation of these "prohibited transaction" rules could result in an excise tax or other liabilities under ERISA and/or Section 4975 of the Code for those persons, unless exemptive relief is available under an applicable statutory or administrative exemption.

The U.S. Department of Labor has issued five prohibited transaction class exemptions ("PTCEs") that may provide exemptive relief for direct or indirect prohibited transactions resulting from the purchase or holding of the Buffered PLUS. Those class exemptions are PTCE 96-23 (for certain transactions determined by in-house asset managers), PTCE 95-60 (for certain transactions involving insurance company general accounts), PTCE 91-38 (for certain transactions involving bank collective investment funds), PTCE 90-1 (for certain transactions involving insurance company separate accounts) and PTCE 84-14 (for certain transactions determined by independent qualified professional asset managers). In addition, ERISA Section 408(b)(17) and Section 4975(d)(20) of the Code provide an exemption for the purchase and sale of securities and the related lending transactions, provided that neither the issuer of the securities nor any of its affiliates has or exercises any discretionary authority or control or renders any investment advice with respect to the assets of the Plan involved in the transaction and provided further that the Plan pays no more, and receives no less, than "adequate consideration" in connection with the transaction (the so-called "service provider" exemption). There can be no assurance that any of these class or statutory exemptions will be available with respect to transactions involving the Buffered PLUS.

Because we may be considered a party in interest with respect to many Plans, the Buffered PLUS may not be purchased, held or disposed of by any Plan, any entity whose underlying assets include "plan assets" by reason of any Plan's investment in the entity (a "Plan Asset Entity") or any person investing "plan assets" of any Plan, unless such purchase, holding or disposition is eligible for exemptive relief, including relief available under PTCEs 96-23, 95-60, 91-38, 90-1, 84-14 or the service provider exemption or such purchase, holding or disposition is otherwise not prohibited. Any purchaser, including any fiduciary purchasing on behalf of a Plan, transferee or holder of the Buffered PLUS will be deemed to have represented, in its corporate and its fiduciary capacity, by its purchase and holding of the Buffered PLUS that either (a) it is not a Plan or a Plan Asset Entity and is not purchasing such Buffered PLUS on behalf of or with "plan assets" of any Plan or with any assets of a governmental, non-U.S. or church plan that is subject to any federal, state, local or non-U.S. law that is substantially similar to the provisions of Section 406 of ERISA or Section 4975 of the Code ("Similar Law") or (b) its purchase, holding and disposition of these Buffered PLUS will not constitute or result in a non-exempt prohibited transaction under Section 406 of ERISA or Section 4975 of the Code or violate any Similar Law.

Due to the complexity of these rules and the penalties that may be imposed upon persons involved in non-exempt prohibited transactions, it is particularly important that fiduciaries or other persons considering purchasing the Buffered PLUS on behalf of or with "plan assets" of any Plan consult with their counsel regarding the availability of exemptive relief.

The Buffered PLUS are contractual financial instruments. The financial exposure provided by the Buffered PLUS is not a substitute or proxy for, and is not intended as a substitute or proxy for, individualized investment management or advice for the benefit of any purchaser or holder of the Buffered PLUS. The Buffered PLUS have not been designed and will not be administered in a manner intended to reflect the individualized needs and objectives of any purchaser or holder of the Buffered PLUS.

Each purchaser or holder of any Buffered PLUS acknowledges and agrees that:

(i) the purchaser or holder or its fiduciary has made and shall make all investment decisions for the purchaser or holder and the purchaser or holder has not relied and shall not rely in any way upon us or our affiliates to act as a fiduciary or adviser of the purchaser or holder with respect to (A) the design and terms of the Buffered PLUS, (B) the purchaser or holder's investment in the Buffered PLUS, or (C) the exercise of or failure to exercise any rights we have under or with respect to the Buffered PLUS;

(ii) we and our affiliates have acted and will act solely for our own account in connection with (A) all transactions relating to the Buffered PLUS and (B) all hedging transactions in connection with our obligations under the Buffered PLUS;

(iii) any and all assets and positions relating to hedging transactions by us or our affiliates are assets and positions of those entities and are not assets and positions held for the benefit of the purchaser or holder;

(iv) our interests are adverse to the interests of the purchaser or holder; and

(v) neither we nor any of our affiliates is a fiduciary or adviser of the purchaser or holder in connection with any such assets, positions or transactions, and any information that we or any of our affiliates may provide is not intended to be impartial investment advice.

Each purchaser and holder of the Buffered PLUS has exclusive responsibility for ensuring that its purchase, holding and disposition of the Buffered PLUS do not violate the prohibited transaction rules of ERISA or the Code or any Similar Law. The sale of any Buffered PLUS to any Plan or plan subject to Similar Law is in no respect a representation by us or any of our affiliates or representatives that such an investment meets all relevant legal requirements with respect to investments by plans generally or any particular plan, or that such an investment is appropriate for plans generally or any particular plan. In this regard, neither this discussion nor anything provided in this document is or is intended to be investment advice directed at any potential Plan purchaser or at Plan purchasers generally and such purchasers of the Buffered PLUS should consult and rely on their own counsel and advisers as to whether an investment in the Buffered PLUS is suitable.

However, individual retirement accounts, individual retirement annuities and Keogh plans, as well as employee benefit plans that permit participants to direct the investment of their accounts, will not be permitted to purchase or hold the Buffered PLUS if the account, plan or annuity is for the benefit of an employee of Morgan Stanley or Morgan Stanley Wealth Management or a family member and the employee receives any compensation (such as, for example, an addition to bonus) based on the purchase of the Buffered PLUS by the account, plan or annuity.

Additional considerations:

Client accounts over which Morgan Stanley, Morgan Stanley Wealth Management or any of their respective subsidiaries have investment discretion are not permitted to purchase the Buffered PLUS, either directly or indirectly.

Supplemental information regarding plan of distribution; conflicts of interest:

Selected dealers, which may include our affiliates, and their financial advisors will collectively receive from the agent a fixed sales commission of $20 for each Buffered PLUS they sell.

MS & Co. is an affiliate of MSFL and a wholly owned subsidiary of Morgan Stanley, and it and other affiliates of ours expect to make a profit by selling, structuring and, when applicable, hedging the Buffered PLUS.

MS & Co. will conduct this offering in compliance with the requirements of FINRA Rule 5121 of the Financial Industry Regulatory Authority, Inc., which is commonly referred to as FINRA, regarding a FINRA member firm's distribution of the securities of an affiliate and related conflicts of interest. MS & Co. or any of our other affiliates may not make sales in this offering to any discretionary account. See "Plan of Distribution (Conflicts of Interest)" and "Use of Proceeds and Hedging" in the accompanying product supplement for PLUS.

Validity of the Buffered PLUS: In the opinion of Davis Polk & Wardwell LLP, as special counsel to MSFL and Morgan Stanley, when the Buffered PLUS offered by this pricing supplement have been executed and issued by MSFL, authenticated by the trustee pursuant to the MSFL Senior Debt Indenture (as defined in the accompanying prospectus) and

	delivered against payment as contemplated herein, such Buffered PLUS will be valid and binding obligations of MSFL and the related guarantee will be a valid and binding obligation of Morgan Stanley, enforceable in accordance with their terms, subject to applicable bankruptcy, insolvency and similar laws affecting creditors' rights generally, concepts of reasonableness and equitable principles of general applicability (including, without limitation, concepts of good faith, fair dealing and the lack of bad faith), *provided* that such counsel expresses no opinion as to (i) the effect of fraudulent conveyance, fraudulent transfer or similar provision of applicable law on the conclusions expressed above and (ii) any provision of the MSFL Senior Debt Indenture that purports to avoid the effect of fraudulent conveyance, fraudulent transfer or similar provision of applicable law by limiting the amount of Morgan Stanley's obligation under the related guarantee. This opinion is given as of the date hereof and is limited to the laws of the State of New York, the General Corporation Law of the State of Delaware and the Delaware Limited Liability Company Act. In addition, this opinion is subject to customary assumptions about the trustee's authorization, execution and delivery of the MSFL Senior Debt Indenture and its authentication of the Buffered PLUS and the validity, binding nature and enforceability of the MSFL Senior Debt Indenture with respect to the trustee, all as stated in the letter of such counsel dated November 16, 2017, which is Exhibit 5-a to the Registration Statement on Form S-3 filed by Morgan Stanley on November 16, 2017.
Contact:	Morgan Stanley Wealth Management clients may contact their local Morgan Stanley branch office or our principal executive offices at 1585 Broadway, New York, New York 10036 (telephone number (866) 477-4776). All other clients may contact their local brokerage representative. Third-party distributors may contact Morgan Stanley Structured Investment Sales at (800) 233-1087.
Where you can find more information:	Morgan Stanley and MSFL have filed a registration statement (including a prospectus, as supplemented by the product supplement for PLUS and the index supplement) with the Securities and Exchange Commission, or SEC, for the offering to which this communication relates. You should read the prospectus in that registration statement, the product supplement for PLUS, the index supplement and any other documents relating to this offering that Morgan Stanley and MSFL have filed with the SEC for more complete information about Morgan Stanley, MSFL and this offering. You may get these documents without cost by visiting EDGAR on the SEC web site at.www.sec.gov. Alternatively, Morgan Stanley, MSFL, any underwriter or any dealer participating in the offering will arrange to send you the product supplement for PLUS, index supplement and prospectus if you so request by calling toll-free 1-(800)-584-6837.

You may access these documents on the SEC web site at.www.sec.gov as follows:

Product Supplement for PLUS dated November 16, 2017

Index Supplement dated November 16, 2017

Prospectus dated November 16, 2017

Terms used but not defined in this document are defined in the product supplement for PLUS, in the index supplement or in the prospectus.

"Performance Leveraged Upside Securities[SM]" and "PLUS[SM]" are our service marks.

April 2019 Page 14

Independent Exploration License exploration Approximate ----------------------------- 2001 drilling contract area Commencement Expiration exploration planned Block (km2) Partner(s) date date drilling for 2002 ---------------------------------- ------------- ------------------- -------------- ---------- ----------- ---------- Independent Huizhou 31...................... 3,074 -- 05/11/01 05/11/06 -- 1 Enping 15....................... 5,833 -- 05/11/01 05/11/06 -- -- Enping 10....................... 6,547 -- 05/11/01 05/11/06 -- -- Panyu 33........................ 4,830 -- 05/11/01 05/11/06 -- 1 Liuhua 07....................... 4,172 -- 05/11/01 05/11/06 1 3 Liuhua 21....................... 4,496 -- 05/11/01 05/11/06 -- -- Liuhua 32....................... 5,796 -- 05/11/01 05/11/06 -- -- Chaotai(1)(2).................. 15,430 -- -- -- -- 1 Production Sharing Contracts 16/19(3)........................ 471 Agip, Chevron/ Texaco 10/08/00 03/31/02 3 16/08.......................... 541 Agip, Chevron/ Texaco 04/29/01 04/29/03 -- 15/34.......................... 5,124 Sante Fe 08/30/00 02/28/04 -- 16/02.......................... 3,498 Sante Fe 03/31/00 03/31/07 1 16/05.......................... 3,009 Sante Fe 03/31/00 03/31/07 1 15/12.......................... 1,895 Shell 10/16/00 10/16/06 -- 16/21(4)........................ 2,241 Burlington 10/16/00 10/16/07 1 15/24(4)........................ 133 Phillips, Shell 05/12/01 05/12/03 1 15/35.......................... 1,439 Sante Fe 08/10/01 01/31/03 -- 27/10(5)........................ 6,546 Sante Fe 10/09/01 10/09/03 -- ----------- (1) Application submitted for exploration license. (2) Joint exploration block with other oil company, planned work load equals joint operation work load. (3) Application submitted for extension of exploration license. (4) Contract completed in 2001, independent exploration license under application. (5) This contract area is located in an independent block, the valid period of which is dependent on that of the exploration license for the independent block. The PSC contract area has been excluded from the total area of the independent block. 40 For the year ended December 31, 2001, we did not acquire any 3D seismic data, while our foreign partners acquired approximately 700 square kilometers of 3D seismic data in the Eastern South China Sea area. We have an aggregate of approximately 49,200 kilometers of independent 2D seismic data in the Eastern South China Sea area. We also have access, through our production sharing contract partners, to approximately another 106,730 kilometers and 5,300 square kilometers of 2D and 3D seismic data, respectively, in this area. We plan to drill five exploration wells in the Eastern South China Sea in 2002. Exploration capital expenditures for the Eastern South China Sea for 2001 were US$8.8 million. Our budgeted exploration capital expenditures for the Eastern South China Sea for 2002 are approximately US$36 million and its budgeted exploration capital expenditures for the area for 2003 are approximately US$24 million. For 2001, daily net production averaged 81,404 barrels per day of crude oil, condensate and natural gas liquids, representing approximately 31.1% of total daily net production. Development capital expenditures for this region for 2001 were US$36.6 million. Our budgeted development capital expenditures for this area for 2002 are approximately US$133 million and our budgeted development capital expenditures for this area for 2003 are approximately US$146 million. The following table sets forth our principal oil and gas properties in the Eastern South China Sea that were under production or development as of December 31, 2001. Net proved reserves Average net Actual or as of production Number of expected December for 2001 net production 31, 2001 Company (BOE per productive commencement (million Block/Field Operator Partner(s) interest day) wells year BOE) -------------------------- ---------------- ---------- ---------- ------------ ------------ ------------- ----------- Production 16/08 Huizhou 21-1........... CACT 51% 3,795 7.7 1990 2.73 Huizhou 26-1........... CACT 51% 14,381 10.2 1991 14.40 Huizhou 32-2........... CACT 51% 3,809 4.6 1995 3.61 Huizhou 32-3...........

CACT 51% 8,943 5.6 1995 8.24 Huizhou 32-5........... CACT 51% 7.075 1.5 1999 2.38 15/11 Xijiang 24-3........... Company/Phillips Shell 51% 14,974 10.7 1994 9.40 Xijiang 30-2........... Company/Phillips Shell 40% 14,590 8.8 1995 16.19 29/04 Liuhua 11-1............ Company/BP Kerr-McGee 51% 8,293 12.8 1996 6.00 16/06 Lufeng 13-1............ JHN 25% 3,451 4.8 1993 5.00 17/22 Lufeng 22-1............ Company/Statoil 25% 2,093 1.3 1997 0.53 Development 16/08 Huizhou 27-1........... CACT 51% -- -- 2005 0.51 Huizhou 33-1........... CACT 51% -- -- 5.58 16/19 Huizhou 19-2........... CACT 51% -- -- 12.84 Huizhou 19-3........... CACT 51% -- -- 2004 11.35 Huizhou 25-1........... CACT 51% -- -- 0.60 15/34 Panyu 4-2.............. Devon Burlington 51% -- -- 2003 16.11 Panyu 5-1.............. Devon Burlington 51% -- -- 2003 16.72 41 East China Sea The East China Sea area is the least explored area of our four principal areas, and an area that we expect to become an important natural gas production base in the future. The East China Sea area is approximately 339,580 square kilometers in size and is located east of Shanghai, an area that has experienced rapid economic growth in recent years. We currently have the exclusive right to operate independently or in conjunction with international oil and gas companies in 164,800 square kilometers of the total East China Sea area. In August 2001, our subsidiary CNOOC China Limited entered into an acquisition agreement with CNOOC, our controlling shareholder, to purchase CNOOC's interest in a joint venture with China Petrochemical Corporation with respect to certain oil and gas fields in the Xihu Trough within the East China Sea area. Typical water depths in this region are approximately 90 meters and crude oil and condensate produced are of light gravity. As of December 31, 2001, our net proved reserves in this region were 12.4 million barrels of crude oil and condensate and 197.0 billion cubic feet of natural gas, totaling 45.2 million BOE and representing less than 3% of our total net proved reserves. During the year ended December 31, 2001, we drilled two wildcat wells in our independent blocks and funded the costs of one appraisal well in a production sharing contract block. The foreign partners did not drill any exploration wells in this area in 2001. We currently have exploration licenses for 40 blocks covering approximately 181,430 square kilometers in the East China Sea. Our production sharing contract partners have licenses for four blocks covering approximately 16,590 square kilometers. The following table sets forth our principal exploration blocks under exploration license or pending exploration license and principal exploration blocks under exploration license to our production sharing contract partners in the East China Sea. Independent Exploration License exploration Approximate ------------------------------ 2001 drilling contract area Commencement Expiration exploration planned Block (km2) Partner(s) date date drilling for 2002 ------------------------------------ -------------- ------------------- --------------- ---------- ----------- ----------- Independent Pinghu(1)...................... N/A Sinopec National N/A N/A -- -- Star, Shanghai Municipal Government Xihu Huangyan 04(2)............ 2,848 -- 08/28/01 08/28/08 -- 5 Xihu Hangzhou 17............... 4,227 -- 08/28/01 08/28/08 -- -- Xihu Zhenghai 01............... 1,536 -- 08/28/01 08/28/08 -- -- Xihu Fuyang 27................. 2,526 -- 08/28/01 08/28/08 -- -- Lishui-Jiaojiang Trough........ 6,767 -- 03/31/00 11/28/05 -- -- Western Wunansha............... 242 -- 03/31/00 12/16/05 1 -- South 2 Trough................. 508 -- 08/30/00 08/30/05 -- -- South 5 Trough................. 481 -- 08/30/00 08/30/05 1 1 North Trough................... 912 -- 08/30/00 08/30/05 -- -- West Trough.................... 2,179 -- 08/30/00 08/30/05 -- 1 Dalian 16...................... 6,471 -- 05/11/01 05/11/06 -- -- Yantai 04...................... 6,109 -- 05/11/01 05/11/06 -- -- Rushang 32..................... 4,413 -- 05/11/01 05/11/06 -- 1 Production Sharing Contracts 32/32.......................... 4,593 Primeline 07/06/00 07/06/02 1 Western 04/20(3)............... 3,530 Primeline 04/06/01 04/06/03 -- Southern 04/20(3).............. 5,309 Primeline 12/31/00 12/31/02 -- Northern 04/20(3).............. 3,155 Primeline 05/25/01 05/25/04 -- ----------- (1) Covered by a production license to the Shanghai Petroleum and Natural Gas Company in which the company has a 30% interest. The production license will expire on December 1, 2020. (2) Joint exploration block with other oil company, planned work load equals joint operation work load. (3) Contract completed in 2001, independent exploration license under application. 42 During the year ended December 31, 2001, neither we nor our foreign partners acquired any 3D seismic data in this area. We have independently acquired an aggregate of approximately 99,400 kilometers and 380 square kilometers, respectively, of 2D and 3D seismic data in the East China Sea area. We also have access, through our production sharing contract partners, to approximately another 47,500 kilometers and 475 square kilometers, respectively, of 2D and 3D seismic data in this area. In 2002, we plan to drill eight exploration wells, five of which will be conducted with other parties, and our foreign partners currently have no plans to drill any exploration wells in the East China Sea. Exploration capital expenditures for the East China Sea for 2001 were US$20.0 million. Our budgeted exploration capital expenditures for the East China Sea for 2002 are approximately US$27 million and our budgeted exploration capital expenditures for the East China Sea for 2003 are approximately US$60 million. For 2001, net production averaged 3,967 barrels per day of crude oil, condensate and natural gas liquids and 9.8 million cubic feet per day of natural gas, representing approximately 2.1% of total daily net production. Development capital expenditures for the East China Sea for 2001 were US$45.0 million and were attributable to our prepayment costs for the acquistion of the Xihu Trough. Our budgeted development capital expenditures for the East China Sea for 2002 are approximately US$25 million and our budgeted development capital expenditures for the East China Sea for 2003 are approximately US$123 million. As the operator of the Pinghu gas field, we pioneered the development of the first oil and gas field in the East China Sea. While first production came on stream in 1998, the next phase of the project expansion is planned for completion in 2003. An additional platform and parallel crude and gas pipelines are planned to be built and installed for production by January 2006. In 2001, we acquired a working interest in the Xihu Trough and its undeveloped Chunxiao gas field, which will be jointly owned with Sinopec and operated by us. The fields include Chunxiao, Tianwaitian, Duanqiao and Canxue gas fields, with the Tianwaitian gas field located 60 kilometers away from Pinghu. We prepaid US$45.0 million for the acquisition. The following table sets forth the principal oil and gas property in the East China Sea that was under production as of December 31, 2001. Net proved reserves Average net Actual or as of production Number of expected December for 2001 net production 31, 2001 Company (BOE per productive commencement (million Block/Field Operator Partner(s) interest day) wells year BOE) -------------------------- ------------- ---------------- ---------- ------------- ---------- ------------ --------- Production Pinghu Pinghu(1).............. Company Sinopec National 30% 5,599 4.5 1998 15.42 Star, Shanghai Municipal Government Development Xihu Canxue................. Company 50% -- -- 11.28 Duanqiao............... Company 50% -- -- 18.50 --------- (1) This field is under license to the Shanghai Petroleum and Natural Gas Company in which the company has a 30% interest. 43 Overseas Activity On January 18, 2002, we, through a wholly owned subsidiary, entered into a share purchase agreement to acquire the Repsol subsidiaries. The nine subsidiaries together hold a portfolio of operated and non-operated interests in oil and gas production sharing and technical assistance contracts in contract areas located offshore and onshore Indonesia. The acquisition of the Repsol subsidiaries is consistent with our plan to expand our production and reserves. Furthermore, we believe the acquisition represents a unique opportunity to acquire producing assets that fit with our offshore expertise and experience. The main businesses of the Repsol subsidiaries are the exploration, development and production of oil and gas offshore and onshore Indonesia. Their main assets comprise a portfolio of operated and non-operated interests in an aggregate of five production sharing and technical assistance contracts in that region. We estimate the net working interest proved reserves of the assets as at January 1, 2002 at approximately 360 million BOE, or approximately 185 million BOE in terms of its net entitlement. The interests owned by the Repsol subsidiaries comprise the following assets: o South East Sumatra Production Sharing Contract. The Repsol subsidiaries own a 65.3% interest in the South East Sumatra production sharing contract. This contract area covers approximately 8,100 square kilometers located offshore Sumatra and is the largest of the assets held by the Repsol subsidiaries. It will be operated and majority owned by the company. It is one of the largest offshore oil developments in Indonesia and has produced more than one billion barrels of oil in over 20 years of production. The concession expires in 2018. o Offshore Northwest Java Production Sharing Contract. The Repsol subsidiaries own a 36.7% interest in the Offshore Northwest Java production sharing contract. This contract area covers approximately 13,800 square kilometers in the Southern Java Sea, offshore Jakarta and has produced more than one billion BOE in over 20 years of production. It is operated by a member of the BP p.l.c. group and currently produces crude oil and natural gas. Its natural gas is sold to the Indonesia State Electric Company and the Indonesia State Gas Utility Company. The concession expires in 2017. o West Madura Production Sharing Contract and Poleng Technical Assistance Contract. The Repsol subsidiaries own a 25.0% interest in the West Madura production sharing contract and a 50.0% interest in the Poleng technical assistance contract. These contract areas are located offshore Java, near the island of Madura and the Java city of Surabaya and cover approximately 1,600 square kilometers combined. Kodeco Energy Company is the operator for the West Madura production sharing contract and Korea Development Co. Ltd. is the operator for the Poleng technical assistance contract, each assisted by certain Repsol subsidiaries. These contract areas currently produce crude oil and natural gas. Their natural gas is sold to the Indonesia State Electric Company. The West Madura production sharing contract expires in May 2011. The Poleng technical assistance contract expires in December 2013. o Blora Production Sharing Contract. The Repsol subsidiaries own a 16.7% interest in the Blora production sharing contract. This contract area lies entirely onshore Java and covers an area of approximately 4,800 square kilometers. There has been no production of crude oil or natural gas from this concession. The current operator is Coparex Blora B.V. The concession expires in 2026. Remaining interests in the above assets are owned by independent third parties. On April 19, 2002, we announced the completion of the acquisition. Upon completion, we entered into a co-operation agreement with Repsol Exploration Services Limited, pursuant to which Repsol Exploration Services Limited will provide consulting assistance to the Repsol subsidiaries on terms determined on an arm's length basis for a period of up to six months, in order to achieve a smooth transition of the businesses of the Repsol subsidiaries. For further information on the acquisition, see "Item 5--Operating and Financial Review and Prospects--The Repsol Acquisition." 44 In addition to the pending acquisition of the Repsol subsidiaries, we currently have a 39.5% participating interest in a production sharing contract in the Malacca Strait in Indonesia. As of December 31, 2001, our net proved reserves in this property were 8.4 million barrels of crude oil. For 2001, net production from this property averaged 2,683 barrels per day of crude oil, condensate and natural gas liquids, representing approximately 1.0% of total daily net production. Production has been declining in recent periods due to water cut increases and natural production declines. Our interests in the production sharing contract are held by our wholly owned subsidiaries. Our budgeted capital expenditures for overseas activity, including the pending acquisition in Indonesia, is approximately US$650 million from 2002 through the end of 2003. We currently conduct all of our international oil sales through China Offshore Oil (Singapore) International Pte. Ltd., our wholly owned Singapore subsidiary. In addition to selling oil in the international market, this subsidiary also trades oil produced by international oil and gas companies. 45 Other Oil and Gas Data Production Cost Data The following table sets forth average sales prices per barrel of crude oil, condensate and natural gas liquids sold, average sales prices per thousand cubic feet of natural gas sold and production costs per BOE produced for our independent, production sharing contract and combined operations for the three years ended December 31, 1999, 2000 and 2001. Year ended December 31, --- 1999 2000 2001 ---------- ----------- ----------- Average Sales Prices of Petroleum Produced Per Barrel of Crude Oil, Condensate and Natural Gas Liquid Sold.................................. US$18.91 US$28.21 US$23.34 Per Thousand Cubic Feet of Natural Gas Sold......... 2.88 3.09 3.08 Average Lifting Costs Per BOE Produced Independent.. US$3.14 US$4.00 US$3.88 Production Sharing Contracts........................ 4.49 4.86 4.51 Combined Operations................................ 3.93 4.45 4.16 Drilling and Productive Wells The following table sets forth our exploratory and productive wells drilled as of December 31, 2001 by independent and production sharing contract operations in each of our operating areas. As of December 31, 2001 -- Western Eastern South South East Bohai China China China Total Bay Sea Sea Sea Overseas ------- --------- ---------- ---------- --------- ---------- Independent Net Exploratory Wells.................... 1,387.0 1,247.0 128.0 2.0 10.0 -- Net Productive Wells...................... 479.0 417.0 62.0 -- -- -- Crude Oil.............................. 468.0 406.0 62.0 -- -- -- Natural Gas............................ 11.0 11.0 -- -- -- -- Production Sharing Contracts Net Exploratory Wells.................... 2.8 -- -- -- 2.0 0.8 Net Productive Wells...................... 107.1 23.5 5.1 68.0 4.5 6.0 Crude Oil.............................. 99.6 23.5 -- 68.0 2.1 6.0 Natural Gas............................ 7.5 -- 5.1 -- 2.4 -- Total Net Exploratory Wells.................... 379.8 247.0 128.0 2.0 2.0 0.8 Net Productive Wells...................... 586.1 440.5 67.1 68.0 4.5 6.0 Crude Oil.............................. 567.6 429.5 62.0 68.0 2.1 6.0 Natural Gas............................ 18.5 11.0 5.1 -- 2.4 -- 46 Drilling Activity The following tables set forth our net exploratory and development wells for the three years ended December 31, 1999, 2000 and 2001 broken down by independent and production sharing contract operations in each of our operating areas. Western Eastern South South East Bohai China China China Total Bay Sea Sea Sea Overseas ------ --------- --------- --------- --------- --------- For the Year Ended December 31, 2001 Independent Net Exploratory Wells Drilled............ 13.0 4.0 6.0 1.0 2.0 -- Successful............................. 5.0 2.0 2.0 1.0 -- -- Dry.................................... 8.0 2.0 4.0 -- 2.0 -- Net Development Wells Drilled............ 76.0 76.0 -- -- -- -- Successful............................ 76.0 76.0 -- -- -- -- Dry.................................... -- -- -- -- -- -- -- -- -- -- -- -- Production Sharing Contracts Net Exploratory Wells Drilled............ 1.0 -- -- -- 1.0 -- Successful............................. -- -- -- -- -- -- Dry.................................... 1.0 -- -- -- 1.0 -- Net Development Wells Drilled............ 41.7 34.7 4.8 -- 0.6 1.6 Successful............................. 40.7 34.7 3.8 -- 0.6 1.6 Dry.................................... 1.0 -- 1.0 -- -- -- Western Eastern South South East Bohai China China China Total Bay Sea Sea Sea Overseas ------ --------- ---------- ---------- --------- --------- For the Year Ended December 31, 2000 Independent Net Exploratory Wells Drilled............ 12.0 5.0 4.0 1.0 2.0 -- Successful............................. 6.0 5.0 1.0 -- -- -- Dry.................................... 6.0 -- 3.0 1.0 2.0 -- Net Development Wells Drilled............ 65.2 61.0 3.0 -- 1.2 -- Successful............................. 65.2 61.0 3.0 -- 1.2 -- Dry.................................... -- -- -- -- -- -- Production Sharing Contracts Net Exploratory Wells Drilled............ 1.8 -- -- -- 1.0 0.8 Successful............................. 1.0 -- -- -- 1.0 -- Dry.................................... 0.8 -- -- -- -- 0.8 Net Development Wells Drilled............ 25.2 22.4 -- -- -- 2.8 Successful............................. 25.2 22.4 -- -- -- 2.8 Dry.................................... -- -- -- -- -- -- 47 Western Eastern South

South East Bohai China China China Total Bay Sea Sea Sea Overseas ------- -------- ---------- ---------- -------- ---------- For the Year Ended December 31, 1999 Independent Net Exploratory Wells Drilled............ 6.0 3.0 3.0 -- -- -- Successful............................. 3.0 2.0 1.0 -- -- -- Dry.................................... 3.0 1.0 2.0 -- -- -- Net Development Wells Drilled............ 123.5 118.0 4.0 -- 1.5 -- Successful............................. 123.5 118.0 4.0 -- 1.5 -- Dry.................................... -- -- -- -- -- -- Production Sharing Contracts Net Exploratory Wells Drilled............ -- -- -- -- -- -- Successful............................. -- -- -- -- -- -- Dry.................................... -- -- -- -- -- -- Net Development Wells Drilled............ 4.7 2.6 -- 0.5 -- 1.6 Successful............................. 4.7 2.6 -- 0.5 -- 1.6 Dry.................................... -- -- -- -- -- -- Natural Gas Business Natural gas is becoming an increasingly important part of our business strategy as we exploit our natural gas reserves to meet rapidly growing domestic demand for natural gas. In view of the domestic natural gas supply shortfall forecasted by the Chinese government, we also plan to participate in liquefied natural gas projects. CNOOC, our controlling shareholder, is currently engaged in a project to build China's first proposed liquefied natural gas import facility in Guangdong Province in southern China. CNOOC has granted us the option to acquire CNOOC's interest in the project. The terms of this option require us, if we exercise the option, to reimburse CNOOC for any contribution CNOOC has made with respect to the facility together with interest thereon calculated at the prevailing market interest rate. We have not entered into any negotiations with CNOOC on the detailed terms under which we may acquire CNOOC's interest in this liquefied natural gas facility. CNOOC has committed to take a 33% ownership interest in the project. Other partners include Hongkong Electric and Hong Kong and China Gas, each committed to 3% ownership interests, and five customers of the proposed facility who have collectively committed to a 31% ownership interest. Through a competitive selection process, BP Global Investment Limited was selected as the foreign partner to take the remaining 30% interest in the project. The project involves the construction of a receiving terminal with capacity of three million metric tons per year, a 215-kilometer trunkline and two branch trunklines with a total length of 111 kilometers. Solicitation tendering for liquefied natural gas suppliers was launched on November 8, 2001. Project construction is expected to begin in the fourth quarter of 2002. The facility is scheduled to commence operations in 2005. The total cost of the facility is estimated to be approximately US$600 million. As described above, CNOOC has granted us the option at no consideration to acquire its 33% interest in this project. We will, however, be required to reimburse CNOOC for any equity contribution it has made to the venture and will be required to fund 33% of any future equity contributions to the venture. CNOOC will help us procure all necessary government approvals for our participation in this project should we exercise this option. We are currently evaluating the exercise of this option and may exercise it at any time. CNOOC has not entered into any definitive agreements with respect to the Guangdong liquefied natural gas facility. 48 We may make other strategic investments in liquefied natural gas projects. We may also make strategic investments in other natural gas businesses in China's coastal provinces to facilitate the development of the market for natural gas production. CNOOC has granted us the option to make any other investments in natural gas-related businesses that CNOOC has made or proposes to make. In addition, we plan to selectively pursue interests in producing natural gas properties outside of China, where appropriate, to secure upstream natural gas supply for any liquefied natural gas projects in which we may participate. To the extent we invest in businesses and geographic areas where we have limited experience and expertise, we plan to structure our investments as alliances and partnerships with parties possessing the relevant experience and expertise. In August 2001, we signed a Memorandum of Understanding with Chevron Australia Pty Ltd. to explore the feasibility of acquiring an equity interest in oil and gas assets in Gorgon field, a large natural gas field in the Gorgon area offshore Western Australia, and to develop the natural gas market in coastal China. In September 2001, CNOOC signed an agreement with Zhejiang Provincial Energy Group Company Limited and Zhejiang Southeast Electric Power Company Limited to invest in a joint venture to develop an intra-provincial natural gas distribution network. CNOOC will hold a 37% equity interest in the joint venture company. We have an option to take CNOOC's share in the joint venture company in an arrangement similar to our option in the Guangdong liquefied natural gas project. The business scope of the joint venture includes the construction, operation and management of natural gas pipelines, the intra-provincial wholesale and distribution of natural gas, and the development of gas-fired power plants and other natural gas related infrastructures and projects. In September 2001, CNOOC signed an agreement with Shandong Province Development Planning Commission and Shandong International Trust & Investment Corporation in connection with the construction of a gas pipeline and the importation of liquefied natural gas in Shandong Province. A steering committee was established by the parties to study the prospect of gas utilization in Shandong Province, including the feasibility of constructing a main gas pipeline in Shandong and importing liquefied natural gas to

Shandong through Qingdao. CNOOC is also exploiting gas sources in Bohai Bay. CNOOC expects that natural gas from Bohai Bay will land in Longkou of Shandong Province in 2003, which can be further transported to Qingdao and Yantai in Shandong Province by pipeline. The pipeline between Longkou and Yantai will be 95 kilometers; the pipeline between Longkou and Qingdao will be 2,101 kilometers. In October 2001, CNOOC signed an agreement with the Fujian provincial government on natural gas market development in Fujian Province. The agreement provides for a joint investment commitment of increasing natural gas supply and gas market development in Fujian by both parties. Both parties are committed to sourcing gas, including liquefied natural gas, from all viable sources, including from offshore production and overseas. The parties also agreed to invest in gas-fired power plants and related infrastructure. We have the option to take CNOOC's working interest in the project. In November 2001, we entered into a Heads of Agreement with BHP Petroleum (Northwest Shelf) Pty Ltd., BP Developments Australia Pty Ltd., Chevron Australia Pty Ltd., Japan Australia LNG (MIMI) Pty Ltd., Shell Development (Australia) Pty Ltd., and Woodside Energy Ltd. on a joint venture to develop Northwest Shelf gas in Australia. We agreed to co-invest in the development of Australia's Northwest Shelf gas project and to produce and process liquefied natural gas to sell to the China markets, subject to the joint venture successfully bidding for the contract to supply liquefied natural gas to an import facility in Guangdong Province, in which CNOOC has an equity interest. Sales and Marketing Sales of Offshore Crude Oil We sell crude oil and natural gas to the PRC market exclusively through our wholly owned PRC subsidiary, CNOOC China Limited, and sales to international markets are carried out by our wholly owned subsidiary, China Offshore Oil (Singapore) International Pte. Ltd., located in Singapore. 49 We report production and sales plans to the State Economic and Trade Commission annually. Based on information provided by China's three crude oil producers, us, PetroChina and Sinopec, the State Development and Planning Commission compiles an overall national plan for coordination of sales. We have been allowed to freely determine where we sell our production both domestically and internationally. Our sales of crude oil to international markets also require us to obtain export licenses issued by the Ministry of Foreign Trade and Economic Cooperation. Historically we have always been able to obtain such export licenses. Pricing We determine our crude oil prices with reference to prices for crude oil of comparable quality in international markets, including a premium or discount mutually agreed upon with our customers according to market conditions at the time of the sale. Prices are quoted in U.S. dollars only, but domestic sales are billed and paid in Renminbi. We currently produce three types of crude oil - Nanhai Light, Medium Grade and Heavy Crude. The table below sets forth the sales and marketing volumes, pricing benchmarks and average realized prices of each of these three types of crude oil for the three years ended December 31, 1999, 2000 and 2001. Year ended December 31, -------------------------------------- 1999 2000 2001 ----------- ---------- --------- Sales and Marketing Volumes (benchmark) (mmbbls)(1) Nanhai Light (APPI(2) Tapis(3))................... 36.9 39.1 32.2 Medium Grade (Daqing OSP(4))...................... 51.6 58.3 57.1 Heavy Crude (APPI(2) Duri(5))..................... 22.3 25.4 37.4 Average Realized Prices (US$/bbl)(6) Nanhai Light..................................... US$19.11 US$29.49 US$24.96 Medium Grade...................................... 18.18 28.98 24.16 Heavy Crude...................................... 15.90 26.53 21.01 Benchmark Prices (US$/bbl) APPI(2) Tapis(3)................................. US$18.61 US$29.53 US$24.99 Daqing OSP(4).................................... 17.70 28.53 23.92 APPI(2) Duri(5).................................. 15.71 26.39 21.26 West Texas Intermediate (US$/bbl)................ US$19.25 US$30.35 US$25.89 ------------- (1) Includes the sales volumes of the company and the foreign partners under production sharing contracts. (2) Asia petroleum price index. (3) Tapis is a light crude oil produced in Malaysia. (4) Daqing official selling price. Daqing is a medium crude produced in northeast China. (5) Duri is a heavy crude oil produced in Indonesia. (6) Includes the average realized prices of the company and the foreign partners under production sharing contracts. The international benchmark crude oil price, West Texas Intermediate, was at US$19.84 per barrel as of December 31, 2001 and US$27.28 per barrel as of April 30, 2002. Markets and Customers We sell most of our crude oil production in the PRC domestic market. We also sell to customers in Korea, Japan, the United States and Australia, as well as to crude oil traders in the spot market. For the years ended December 31, 1999, 2000 and 2001, we sold approximately 83.7%, 67.0% and 79.9%, respectively, of crude oil in the PRC, and exported approximately 16.3%, 33.0% and 20.1%, respectively. Most of our crude oil production sales in the PRC domestic market are to refineries and petrochemical companies that are affiliates of Sinopec and PetroChina. Sales volume to Sinopec has been high historically because 50 most of the PRC refineries and petrochemical companies were affiliates of Sinopec. After the restructuring of the PRC petroleum industry in July 1998, some refineries and petrochemical companies were transferred to PetroChina from Sinopec. As a result, sales to Sinopec decreased and sales to PetroChina increased. For the years ended December 31, 1999, 2000 and 2001, sales to

Sinopec were approximately 68.6%, 52.8% and 52.7%, respectively, and sales to PetroChina were approximately 11.8%, 12.6% and 13.8%, respectively, of total oil and gas sales in the PRC domestic market. These customers represented in aggregate approximately 80.4%, 65.4% and 66.5%, respectively, of total oil and gas sales in the PRC domestic market. In recent years we have diversified our domestic client base by targeting companies not affiliated with Sinopec or PetroChina. These targeted companies typically are involved in bitumen processing, fuel blending and mixing, power generation and production of fertilizer feed stocks. We plan to continue our efforts to diversify our client base. The following table presents, for the periods indicated, our revenues sourced in the PRC and outside the PRC: Year ended December 31, --------------------------------------- 1999 2000 2001 ---------- ---------- ---------- (US$ in millions, except percentages) Revenues sourced in the PRC.......................... 11,140 17,559 18,105 Revenues sourced outside the PRC..................... 4,170 6,665 2,715 -------- ------ ------ Total revenues....................................... 15,310 24,224 20,820 % of revenues sourced outside the PRC................ 27.2% 27.5% 13.0% ======== ====== ====== Sales Contracts We sign sales contracts with customers for each cargo. Sales contracts are standard form contracts containing ordinary commercial terms such as quality, quantity, price, delivery and payment. All sales are made on free-on-board terms. PRC customers are required to make payments within 30 days after the shipper takes possession of the crude oil cargo at our delivery points. During the years ended December 31, 1999, 2000 and 2001, the accounts receivable turnover was approximately 51.6 days, 39.5 days and 32.3 days, respectively. Doubtful accounts provision during the years ended December 31, 1999, 2000 and 2001 was Rmb 65.3 million, Rmb 15.7 million and Rmb 10.7 million, respectively. We have a credit control policy, including credit investigation of customers and periodic assessment of credit terms. Sales clerks are directly responsible for liaising with the customers on the collection of receivables within the credit terms. We price our crude oil in U.S. dollars only. PRC customers are billed and make actual payments in Renminbi based on the exchange rate prevailing at the bill of lading date, while overseas customers are billed and are required to make payments in U.S. dollars within 30 days of the bill of lading date. Sales of Offshore Natural Gas Driven by environmental and efficiency concerns, the PRC government is increasingly encouraging residential and industrial use of natural gas to meet primary energy needs. In 1989, in order to encourage natural gas production, the PRC government adopted a favorable royalty treatment, which provides a royalty exemption for natural gas production up to two billion cubic meters (70.6 billion cubic feet or 11.8 million BOE) per year as compared to a royalty exemption available for crude oil production of up to one million tons or approximately seven million BOE per year. The favorable treatment also includes lower royalty rates on incremental increases in natural gas production as compared with the royalty rates for crude oil production. 51 Since 1989, the PRC government has adopted the following sliding scale of royalty payments of up to 3% of the annual gross production of natural gas: Annual gross production Royalty rate ---------------------- ------------ Less than 2 billion cubic meters... 0.0% 2-3.5 billion cubic meters.. 1.0% 3.5-5 billion cubic meters.. 2.0% Above 5 billion cubic meters.. 3.0% We sell a large portion of our natural gas production in Hong Kong. The remaining natural gas production is sold to customers in mainland China. Of the 71.2 billion cubic feet of natural gas that we produced offshore China in the year ended December 31, 2001, 50.7 billion cubic feet, or approximately 71.2%, was produced from the Yacheng 13-1 gas field. This field is governed by a production sharing contract we entered into with BP and Kufpec. We hold a 51% participating interest in this field. In December 1992, Castle Peak Power in Hong Kong signed a long-term gas supply contract under which it agreed to buy from the partners approximately 102.4 billion cubic feet of natural gas per year on a take-or-pay basis until 2015. Gas prices are quoted and paid in U.S. dollars. The payments are made in U.S. dollars monthly and are reconciled annually. Castle Peak Power purchased approximately 61.7% of our total natural gas production for the year ended December 31, 2001. Castle Peak Power is a 60/40 joint venture between Exxon Mobil and CLP Power Hong Kong Limited, a public utility company in Hong Kong. The remaining 38.3% of the company's total natural gas production in the year ended December 31, 2001 was sold to PRC customers including Hainan Fertilizer, Hainan Power, Shanghai Gas, Jingxi Chemical, Xinao Gas, Tianjin Binhai Power and Tianjin Binhai Gas. The price of gas sold to the PRC market is determined by negotiations between us and the buyers based on market conditions. Contracts typically consist of a base price with provisions for annual resets and adjustment formulas which depend on a basket of crude prices, inflation and various other factors. Procurement of Services We usually outsource work in connection with the acquisition and processing of seismic data, reservoir studies, well drilling services, wire logging and perforating services and well control and completion service to independent third parties or CNOOC's affiliates. In the development stage, we normally employ independent third parties for mooring and oil tanker transportation services and both independent third parties and affiliates of CNOOC for other services by entering into contracts with them. We conduct a bidding process to determine who we employ to construct platforms, terminals and pipelines, to drill production wells and to transport offshore production facilities. Both independent third parties and affiliates of CNOOC participate in the bidding process. We are closely involved in the design and management of services by contractors and exercise extensive control over their performance, including their costs, schedule and quality. Competition Domestic Competition The petroleum industry is highly competitive. We compete in the PRC and international markets for both customers and capital to finance its exploration, development and production activities. Our principal competitors in the PRC market are PetroChina and Sinopec. We price our crude oil on the basis of comparable crude oil prices in the international market. The majority of our customers for crude oil are refineries affiliated with Sinopec and PetroChina to which we have been selling crude oil, from time to time, since 1982. Based on its dealings with these refineries, we believe that we have established a stable business relationship with them. In 1998, the PRC government restructured PetroChina and Sinopec into vertically integrated companies, with each having both upstream and downstream petroleum businesses and operations. 52 We are the dominant player in the oil and gas industry offshore China and are the only company authorized to engage in oil and gas exploration and production offshore China in cooperation with foreign parties. We may face increased competition in the future from other petroleum companies in obtaining new PRC offshore oil and gas properties, or, as a result of changes in current PRC laws or regulations permitting an expansion of existing companies' activities or new entrants into the industry. As part of our business strategy, we intend to expand our natural gas business to meet rapidly increasing domestic demand. Our competitors in the PRC natural gas market are PetroChina and, to a lesser extent, Sinopec. Our principal competitor, PetroChina, is the largest supplier of natural gas in China in terms of volume of natural gas supplied. PetroChina's natural gas business benefits from strong market positions in Beijing, Tianjin, Hebei Province and northern China. We intend to invest in related natural gas businesses in China's eastern coastal provinces, where we may face competition from PetroChina and, to a lesser extent, Sinopec. We believe that our extensive natural gas resources base, the proximity of these resources to the markets in China, our relatively advanced technologies and our experienced management team will enable us to compete effectively in the domestic natural gas market. Foreign Competition and the World Trade Organization Imports of crude oil are subject to tariffs, import quotas, handling fees and other restrictions. The PRC government also restricts the availability of foreign exchange with which the imports must be purchased. The combination of tariffs, quotas and restrictions on foreign exchange has, to some extent, limited the competition from imported crude oil. In line with the general progress of its economic reform programs, the PRC government has agreed to reduce import barriers as part of its WTO commitments. As a result of China joining the World Trade Organization as a full member on December 11, 2001, it is required to further reduce its import tariffs and other trade barriers over time, including with respect to certain categories of petroleum and crude oil. All import quotas and licenses for processed oil are expected to be eliminated by 2004. Notwithstanding China's WTO related concessions, crude and processed oil remain, for the time being, subject to restrictions on import rights and only certain designated state owned enterprises may import crude and processed oil. Sinopec and PetroChina have received permission to import crude oil on their own. Currently, there is no set schedule for the liberalization of trading rights that would allow foreign owned or foreign invested entities to participate in the import of crude or processed oil. PRC Fiscal Regimes for Offshore Crude Oil and Natural Gas Activities We conduct exploration and production operations either independently or jointly with foreign partners under our production sharing contracts. The PRC government has established different fiscal regimes for crude oil and natural gas production from our independent operations and from our production sharing contracts. Royalties paid to the PRC government are based on our gross production with respect to each of our independent oil and gas fields and with respect to each of our oil and gas fields covered by production sharing contracts. The amount of the royalties is a varying percentage up to 12.5% based on the annual production of the relevant property. The PRC government has provided the company with a royalty exemption for up to one million tons, or seven million BOE per year, for our crude oil production and for up to 70.6 billion cubic feet, or 11.8 million BOE per year, for our natural gas production. The limits in these exemptions apply to our total production from both independent properties and properties subject to production sharing contracts. In addition, we pay production taxes to the PRC government equal to 5% of our crude oil and gas produced independently and 5% of our crude oil and gas produced under production sharing contracts. Under our production sharing contracts, production of crude oil and gas is allocated among us, the foreign partners and the PRC government according to a formula contained in the contracts. Under this formula, a percentage of production under our production sharing contracts is allocated to the PRC government as its share oil. For more information about the allocation of production under the production sharing contracts, see "--Production Sharing Contracts--Production Sharing Formula." 53 Production Sharing Contracts When exploration and production operations are conducted through a production sharing contract, the operator of the oil or gas field must submit a detailed evaluation report and an overall development plan to CNOOC upon discovery of petroleum reserves. The overall development plan must also be submitted to a joint management committee established under the production sharing contract. After CNOOC confirms the overall development plan, CNOOC submits it to the State Development and Planning Commission for approval. After receiving the governmental approval, the parties to the production sharing contract may begin the commercial development of the petroleum field. As part of the reorganization, CNOOC transferred all of its economic interests and obligations under its existing production sharing contracts to us and our subsidiary, CNOOC (China) Limited. As of December 31, 2001, we had 10 production sharing contracts in the production and development stages, and 20 in the exploration stage. Under PRC law, the negotiation of a production sharing contract is a function that only a national company, such as CNOOC, can perform. This function cannot be transferred to us because we are a pure commercial entity. Since the reorganization, under the terms of its undertaking with us, CNOOC, after entering into production sharing contracts with international oil and gas companies, is required to assign immediately to us all of its economic interests and obligations under the production sharing contracts. For further details, see "Item 7--Major Shareholders and Related Party Transactions." New production sharing contracts are entered into between CNOOC and foreign partners primarily through bidding organized by CNOOC and, to a lesser extent, through direct negotiation. Bidding Process The typical bidding process involves the following major steps: o CNOOC determines which blocks, with the approvals of the PRC government, are open for bid and prepare geological information packages and bidding documentation for these blocks; o CNOOC invites foreign enterprises to bid; o potential bidders are required to provide information, including estimates of minimum work commitment, exploration costs and percentage of share oil payable to the PRC government; and o CNOOC evaluates each bid and negotiates a production sharing contract with the successful bidder. Under CNOOC's undertaking with us, we may participate with CNOOC in all negotiations of new production sharing contracts. A typical production sharing contract has a term not exceeding 30 years with three distinct phases: Exploration. The exploration period generally lasts for seven consecutive years depending on the size of the contract area, and may be extended with the consent of CNOOC. During this period, exploratory and appraisal work on the exploration block is conducted in order to discover petroleum and to enable the parties to determine the commercial viability of any petroleum discovery. Development. The development period begins on the date that the overall development plan, which outlines, among other things, the recoverable reserves and schedule for the development of the discovered petroleum reserves, is approved by the relevant PRC regulatory authorities. Once the design, construction, installation, drilling and related research work for the realization of petroleum production have been completed, the development period comes to an end. Production. The production period begins on the date of the commencement of commercial operations and usually lasts for 15 years. The production period may be extended upon approval of the PRC government. 54 Minimum Work Commitment Under production sharing contracts that include exploration, foreign partners must complete a minimum amount of work during the exploration period, generally including: o a minimum number of exploration wells to be drilled; o a fixed amount of seismic data to be produced; and o a minimum amount of exploration expenditures to be incurred. Foreign partners are required to bear all exploration costs during the exploration period. However, such exploration costs can be recovered according to the production sharing formula after commercial discoveries are made and production begins. During the exploration period, foreign partners are required to return 25% of the contract areas, excluding the development and production areas, to CNOOC at the end of each of the third year and fifth year of the exploration period. At the end of the exploration period, all areas, excluding the development areas, production areas and areas under evaluation, must be returned to CNOOC. Participating Interests Under production sharing contracts, CNOOC has the right to take up to a 51% participating interest in any oil or gas field discovered in the contract area and may exercise the right after the foreign partners have made commercially viable discoveries. The foreign partners retain the remaining participating interests. Production Sharing Formula A chart illustrating the production sharing formula under our production sharing contracts is shown below. -- Percentage of total production Allocation

--- 5.0% Production Taxes to PRC government -- 62.5% 12.5%(a) Royalty oil to PRC Government -- (Royalty and cost recovery oil) 50.0%(a) Cost recovery oil allocated with following priority: (1) Recovery of current year operating costs by us and foreign partner(s). (2) Recovery of earlier exploration costs of foreign partner(s). (3) Recovery of development costs by us and foreign partner(s) based on respective participating interests.(c) (4) Any excess, distributed proportionately to each partner's respective participating interest.(c) --- (1-X) Share oil to PRC Government 32.5%(b) multiplied by (Remainder oil) 32.5% -- X multiplied by Allocable remainder oil distributed proportionate to each 32.5% partner's respective participating interest.(c) --- ---------- (a) Assumes annual gross production of more than four million metric tons, approximately 30 million barrels of oil. For lower amounts of production, the royalty rate will be lower and the cost recovery will be greater than 50.0% by the amount that the royalty rate is less than 12.5%. (b) The ratio "X" is agreed in each production sharing contract based on commercial considerations and ranges from 8% to 100%. (c) See "--Principal Oil and Gas Regions" for our participating interest percentage in each production sharing contract. 55 Annual gross production of petroleum is shared in the following order: 1. The first 5% of the annual gross production is deducted as production taxes paid to the PRC government. 2. The next 62.5% of the annual gross production, which is referred to as "royalty and cost recovery oil," is allocated in the following order: First, since 1989, the PRC government has adopted the following sliding scale of royalty payment of up to 12.5% of the annual gross production: Annual gross production of oil(1) Royalty rate ------------------------------- ------------ Less than 1 million tons.............................. 0.0% 1-1.5 million tons.................................... 4.0% 1.5-2.0 million tons.................................. 6.0% 2.0-3.0 million tons.................................. 8.0% 3.0-4.0 million tons.................................. 10.0% Above 4 million tons.................................. 12.5% ----------------- (1) The sliding scale royalty for natural gas reaches a maximum at 3%. Second, the balance of the royalty and cost recovery oil is allocated in the following order: o to recover actual operating costs required for the production operations incurred by both parties in the current year; o to recover exploration costs, excluding interest accrued thereon, incurred but not yet recovered by foreign partners during the exploration period; and o to recover development investments incurred but not yet recovered, and interest accrued in the current year, according to the participating interest split between us and foreign partners. 3. The last 32.5% of the annual gross production, which is referred to as "remainder oil," is distributed to the PRC government, us and foreign partners according to a pre-determined "ratio X" that is based on a percentage agreed to by CNOOC and the foreign partners in each production sharing contract. Remainder oil is distributed in the following order: o First, an amount of oil and gas equal to the product of "remainder oil" and one minus the "ratio X" is distributed to the PRC government. This portion is referred to as "share oil;" and o Second, the balance of the remainder oil, which is referred to as "allocable remainder oil," is distributed to us and foreign partners. Each party will receive an amount of oil or gas equal to the product of "allocable remainder oil" multiplied by its respective percentage of participating interests. We pay the estimated production taxes and royalties at the time of each shipment for crude oil production, and monthly for natural gas production. At the end of each year, we calculate the production taxes and royalties on an annual basis and file the information with the PRC tax bureau. Any overpayment or underpayment of production taxes and royalties during the year will be adjusted at year-end. The foreign partners have the right either to take possession of their crude oil for sale in the international market, or to sell such crude oil to us for resale in the PRC market. Management and Operator Under each production sharing contract, a party will be designated as an operator to undertake the execution of the production sharing contract which includes: 56 o preparing work programs and budgets; o procuring equipment and materials relating to operations; o establishing insurance programs; and o issuing cash-call notices to the parties to the production sharing contract to raise funds. A joint management committee, which usually consists of six or eight persons, is set up under each production sharing contract to perform supervisory functions, and each of our company and the foreign partners as a group has the right to appoint an equal number of representatives to form the joint management committee. The chairman of the joint management committee is the chief representative designated by us and the vice chairman is the chief representative designated by the foreign partners as a group. The joint management committee has the authority to make decisions on matters including: o reviewing and approving operational and budgetary plans; o determining the commercial viability of each petroleum discovery; o reviewing and adopting the overall development plan; and o approving significant procurements and expenditures, and insurance coverages. Daily operations of a property subject to the respective production sharing contract are carried out by the designated operator. The operator is typically responsible for determining and executing operational and budgetary plans and all routine operational matters. Upon discovery of petroleum reserves, the operator is required to submit a detailed overall development plan to the joint management committee. After the foreign partner has fully recovered its exploration and development costs under production sharing contracts in which the foreign partner is the operator, we have the exclusive right to take over the operation of the particular oil or gas field. With the consent of the foreign partner, we may also take over the operation before the foreign partner has fully recovered its exploration and development costs. Ownership of Data and Assets All data, records, samples, vouchers and other original information obtained by foreign partners in the process of exploring, developing and producing offshore petroleum become the property of CNOOC as a state-owned national oil company under PRC law. Through CNOOC, we have unlimited and unrestricted access to the data. We and our foreign partners have joint ownership in all of the assets purchased, installed or constructed under the production sharing contract until either: o the foreign partners have fully recovered their development costs, or o upon the expiration of the production sharing contract. After that, as a state-owned national oil company under PRC law, CNOOC will assume ownership of all of the assets under the production sharing contracts, but we and the foreign partners retain the exclusive right to use the assets during the production period. Abandonment Costs Any party to our production sharing contracts must give prior written notice to the other party or parties if it plans to abandon production of the oil or gas field within the contracted area. If the other party or parties agrees to abandon production from the oil or gas field, all parties pay abandonment costs in proportion to their respective percentage of participating interests in the field. If we decide not to abandon production upon notice from a foreign partner, all of such foreign partner's rights and obligations under the production sharing contract in respect of the oil or gas field, including the responsibilities for payment of abandonment costs, terminate automatically. We will bear the abandonment costs if we decide to abandon production after an initial decision to proceed with production. We 57 have not incurred any abandonment costs to date but expect that we may incur such costs beginning in 2002 when some of our fields are shut down after their production period expires. Production Tax The PRC production tax rate on the oil and natural gas produced under production sharing contracts is currently 5%. Geophysical Survey Agreements We conduct our exploration operations through geophysical survey agreements with leading international oil and gas companies as well as independently and through production sharing contracts. As of December 31, 2001, we were no longer a party to any geophysical survey agreements, but may enter such agreements in the future. Geophysical survey agreements are designed for foreign petroleum companies to conduct certain geophysical exploration before they decide whether to enter into production sharing contract negotiations with CNOOC. Geophysical survey agreements usually have a term of less than two years. International oil and gas companies must complete all of the work confirmed by both parties in the agreements and bear all the costs and expenses. If a foreign partner decides to enter into a production sharing contract with CNOOC, the costs and expenses that the foreign partner incurs in conducting geophysical survey may be recovered by the foreign partner in the production period subject to our confirmation. CNOOC has the sole ownership of all data and information obtained by the foreign partner during the geophysical survey, and, through CNOOC, we have access to all such data. Under PRC law, the negotiation of a geophysical survey agreement is a function that only a national company, such as CNOOC, can perform. As part of the reorganization, CNOOC transferred to us all its commercial rights under an existing geophysical survey agreement. In the future, CNOOC has agreed to assign to us all of its commercial rights under any geophysical survey agreements it enters into with international oil and gas companies. Operating Hazards and Uninsured Risks Our operations are subject to hazards and risks inherent in the drilling, production and transportation of crude oil and natural gas, including pipeline ruptures and spills, fires, explosions, encountering formations with abnormal pressures, blowouts, cratering and natural disasters, any of which can result in loss of hydrocarbons, environmental pollution and other damage to our properties and the properties of operators under production sharing contracts. In addition, certain of our crude oil and natural gas operations are located in areas that are subject to tropical weather disturbances, some of which can be severe enough to cause substantial damages to facilities and interrupt production. As protection against operating hazards, we maintain insurance coverage against some, but not all, potential losses, including the loss of wells, blowouts, pipeline leakage or other damage, certain costs of pollution control and physical damages on certain assets. Our insurance coverage includes oil and gas fields property and construction insurance, marine hull insurance, protection and indemnity insurance, drilling equipment insurance, marine cargo insurance and third party and comprehensive general liability insurance. It also carries business interruption insurance for Pinghu field. We currently maintain in total approximately Rmb 34.4 billion in insurance coverage and pay an annual insurance premium of approximately Rmb 180 million to maintain that coverage. We believe that our level of insurance is adequate and customary for the PRC petroleum industry. However, we may not have sufficient coverage for some of these risks, either because insurance is not available or because of high premium costs. See "Item 3--Key Information--Risk Factors." For the years ended December 31, 1999, 2000 and 2001, we experienced total losses of approximately Rmb 390 million. 58 Research and Development During the three years ended December 31, 1999, 2000 and 2001, we used research and development services provided by CNOOC's affiliates as well as other international entities. We are trying to develop more efficient and effective approaches to explore for new reserves. Our research efforts have been focusing on: o advanced resolution enhancement technology; o building up exploration and development data bases to improve the efficiency of our research efforts; and o consolidating multi-discipline data to optimize the selection of exploration sites. We are also studying various ways of better utilizing our existing reserves including: o building more accurate reservoir models; o re-processing existing seismic and log data to locate potential areas near existing fields to be integrated into existing production facilities; and o researching ways to reduce development risks for marginal fields and to group fields for joint developments sharing common facilities. We will continue to use research and development services provided by CNOOC's affiliate, China Offshore Oil Research Center. During the three years ended December 31, 1999, 2000 and 2001, we spent approximately Rmb 115 million, Rmb 104 million and Rmb 109 million, respectively, on general research and development activities. For further information regarding our agreement with the China Offshore Oil Research Center, see "Item 7--Major Shareholders and Related Party Transactions--Related Party Transactions." Environmental Regulation Our operations in China are required to comply with various PRC environmental laws and regulations administered by the central and local government environmental protection bureaus. We are also subject to the environmental rules introduced by the local PRC governments in whose jurisdictions the various onshore logistical support facilities are located. The State Environmental Protection Bureau sets national environmental protection standards and local environmental protection bureaus may set stricter local standards. The relevant environment protection bureau must approve or review each stage of a project. We must file an environmental impact statement or, in some cases, an environmental impact assessment outline before an approval can be issued. The filing must demonstrate that the project conforms to applicable environmental standards. The relevant environmental protection bureau generally issues approvals and permits for projects using modern pollution control measurement technology. The PRC national and local environmental laws and regulations impose fees for the discharge of waste substances above prescribed levels, require the payment of fines for serious violations and provide that the PRC national and local governments may at their own discretion close or suspend any facility which fails to comply with orders requiring it to cease or cure operations causing environmental damage. For the three years ended December 31, 1999, 2000 and 2001, we experienced a total of 2 incidents of crude oil discharge with a total volume of approximately 240 barrels being wrongfully discharged and spilled offshore, for which fines in an aggregate amount of Rmb 31,900 (US$3,854) were imposed. None of the incidents nor the aggregate amount of such fines had a material adverse effect on our business or results of operations. The PRC environmental laws do not currently require offshore petroleum developers to pay abandonment costs. Our financial statements include provisions for costs associated with the dismantling and abandonment of 59 abandoned fields during the years ended December 31, 1999, 2000 and 2001 of approximately Rmb 177 million, Rmb 104 million and Rmb 90.4 million, respectively. Environmental protection and prevention costs and expenses in connection with the operation of offshore petroleum exploitation are covered under each individual production sharing contract. Environmental protection and prevention costs and expenses represented approximately 4% of our average operating costs relating to projects constructed during the three years ended December 31, 2001. Each platform has its own environmental protection and safety staff responsible for monitoring and operating the environmental protection equipment. However, no assurance can be given that the PRC government will not impose new or stricter regulations which would require additional environmental protection expenditures. We are not currently involved in any environmental claims and believes that our environmental protection systems and facilities are adequate for us to comply with applicable national and local environmental protection regulations. Legal Proceedings We are not a defendant in any material litigation, claim or arbitration, and we know of no pending or threatened proceeding which would have a material adverse effect on our financial condition. Patents and Trademarks We own or have licenses to use two trademarks which are of value in the conduct of our business. CNOOC is the owner of the "CNOOC" trademark. Under two non-exclusive license agreements between CNOOC and us, we have obtained the right to use this trademark for a nominal consideration. Real Properties Our corporate headquarters is located in Hong Kong. We also lease several other properties from CNOOC in China and Singapore. The rental payments under these lease agreements are determined with reference to market rates. For further details regarding the terms of these leases, see "Item 7--Major Shareholders and Related Party Transactions." We own the following property interests in the PRC: o land, various buildings and structures at Xingcheng JZ 20-2 Natural Gas Separating Plant, Dongyao Village, Shuangsu Township, Xingcheng City, Liaoning Province; o land, various buildings and structures located at Boxi Processing Plant, South of Jintang Subway, Tanggu District, Tianjin City; o land, various buildings and structures at Weizhou Terminal Processing Plant, Weizhou Island, Weizhou Town, Beihai City, Guangxi Zhuang Autonomous Region; and o a parcel of land at Suizhong 36-1 Base, Xiaolihuang Village, Gaoling Town, Suizhong County, Liaoning Province. Employees and Employee Benefits During the three years ended December 31, 1999, 2000 and 2001, we employed approximately 920, 1,007 and 1,081 persons, respectively. Of these 1,081 persons employed as of December 31, 2001, approximately 38% are management staff and the remainder are professional personnel. Of these 1,081 employees, approximately 80% were involved in petroleum exploration, development and production activities, approximately 11% were involved in accounts and finance work and the remainder were senior management, coordinators of production sharing contracts and safety and environmental supervisors. Workers for the operation of our oil and gas fields, maintenance personnel and ancillary service workers are hired on a contract basis. 60 We have a trade union that: o protects employees' rights, o organizes educational programs, o assists in the fulfillment of economic objectives, o encourages employee participation in management decisions, and o assists in mediating disputes between us and individual employees. We have not been subjected to any strikes or other labor disturbances and we believe that our relations with our employees are good. The total remuneration of our employees includes salary, bonuses and allowances. Bonus for any given period is based primarily on individual and company performance. Employees also receive subsidized housing, health benefits and other miscellaneous subsidies. We have implemented an occupational health and safety program similar to that employed by other international oil and gas companies. Under this program, we closely monitor and record health and safety incidents and promptly report them to government agencies and organizations. On March 15, 2000, we finalized and implemented our occupational health and safety program. We believe this program is broadly in line with the United States government Occupational Safety & Health Administration guidelines. All our full-time employees in the PRC are covered by a government regulated pension. The PRC government is responsible for the pension liabilities to these retired employees. We are required to contribute monthly an average of approximately 9% to 22.5% of our employees' basic salaries, with each employee contributing 4% to 7% of his or her base salary for retirement. The contributions vary from region to region. For further details regarding our retirement benefits, see note 26 to the consolidated financial statements. Health, Safety and Environmental Policies Employees' health and safety are crucial for our success and development and everyone plays a part in creating healthy, safe and environmentally friendly results. In order to monitor our production activities and to provide proper guidelines for employees, we have established a set of comprehensive health, safety and environmental ("HSE") policies which constitutes an important part of our corporate culture and which we believe represents one of our core competitive strengths. With the goal of further improving levels of health, safety and environmental protection, we continued during 2001 to implement established HSE systems and key programs and realized our HSE targets set at the beginning of the year. During the year, we experienced no fatalities, no incidents of oil spillage of material quantities, and no single incident resulting in an economic loss exceeding US$120,000. The OHSA statistics on occupational injury and occupational disease showed a significant improvement compared to previous years with both incident and the days-away rates. As a result, our HSE performance was above the average standards for international oil companies. 61 CNOOC Limited occupational injury & occupational disease statistics of 2001 Number of days away Incident rate rate (Times/200,000 Man Hour) (Day/200,000 Man Hour) --- -------------------- Number of days away Death & Number Average Recordable & working number of of days Number of days away & Scope person Man-hour cases bounds days away away working bounds ----- ------- ---------- ---------- --------- --------- ------- -------------------- Permanent worker 1,402 2,228,512 0.00 0.00 0.00 0.00 0.00 Permanent worker, & 5,847 12,187,935 0.20 0.15 0.16 0.15 1.77 other worker & direct contractor Community Contributions Besides constantly trying to increase efficiency and create value for our shareholders, we have also been taking an active part in community activities. During the year, as part of our efforts to make additional significant contributions to society, we participated in "Project Hope", greening activities, educational sponsorships, and other social charitable events. In conjunction with foreign cooperative partners, we participated in the "Century Forest Green Action - Bid for 2008 Olympics", and planted 220 "Olympic Bid" trees in Bijiashan Garden, Shenzhen engraved with our logo. Human Resources Development We believe quality, creativity and dedication of our employees represent our most precious assets and are the major driving forces for our continued growth. As such, we have committed ourselves to formulating and implementing a series of long-term and short-term human resources strategies that are in line with the development objectives of our company and our employees. In 2001, we have been regularly enhancing the employee evaluation systems and strengthening the management and mobility of human resources. We have also established a recruitment system on the Internet to attract talent worldwide. To reward outstanding achievers, we launched a share option scheme for the senior management on February 4, 2001 based on the long-term profit and risk sharing relationship between our senior management and us. Under this scheme, our compensation committee will, from time to time, make its proposal for board approval on the number of options to be granted to the eligible participants. See "Item 6 - Directors, Senior Management and Employees - Share Ownership" for further details on our share option schemes. In 1999, we established a "Chairman's Special Award" to reward business units and individuals who have made outstanding contributions in the areas of production, management and research. In 2001, a total of four business units and 44 employees received the award. During 2001, based on the human resources development strategy for the future and the results from the employee evaluation system, we established a series of target training initiatives and organized a variety of training programs. During the year, a total of 325 training workshops were held with over 7,000 participants attending these workshops. 62 ITEM 5. Operating and Financial Review and Prospects A. OPERATING RESULTS The following discussion and analysis should be read in conjunction with our consolidated financial statements, selected historical consolidated financial data and operating and reserves data, in each case together with the accompanying notes, included elsewhere in this annual report. The consolidated financial statements have been prepared in accordance with Hong Kong GAAP, which differ in certain material respects from U.S. GAAP. Note 36 to the consolidated financial statements provides a reconciliation to U.S. GAAP of net income, shareholders' equity and cash flows. Overview of Our Operations We are an oil and gas company that engages primarily in the exploration, development and production of crude oil and natural gas offshore China. We are the dominant producer of crude oil and natural gas offshore China and the only company permitted to conduct exploration and production activities with international oil and gas companies offshore China. As of December 31, 2001, we had estimated net proved reserves of 1,787.1 million BOE, comprised of 1,245.9 million barrels of crude oil and condensate and 3,247.6 billion cubic feet of natural gas. For the year 2001, our net production averaged 228,874 barrels per day of crude oil, condensate and natural gas liquids and 195.0 million cubic feet per day of natural gas, which together totaled approximately 261,379 BOE per day. Our revenues and profitability are largely determined by the difference between prices received for crude oil and natural gas produced by us and our costs of finding, developing and producing these hydrocarbons. A substantial decline in crude oil prices began in 1997 and continued in 1998, with crude oil prices falling to a 12-year low of US$10.76 per barrel in December 1998. The lower crude oil prices had a significant negative impact on the company's net sales and net income in 1998, although the company still recorded positive income of Rmb 1,549.5 million in that year. As crude oil prices began to recover in April 1999, reaching a peak of US$37.21 per barrel on September 20, 2000, the company recorded significantly higher net income of Rmb 4,111.4 million in 1999 and Rmb 10,296.6 million in 2000. Crude oil prices have declined since then. The decline in crude oil prices, particularly in the second half of 2001, has adversely impacted the company's operating results. The international benchmark crude oil, West Texas Intermediate, was at US$19.84 per barrel as of December 31, 2001 and US$27.28 per barrel as of April 30, 2002. Most of our crude oil production is sold in the PRC domestic market to customers affiliated with Sinopec or PetroChina. Most of our natural gas production is sold to Castle Peak Power Company Limited under a long-term take-or-pay contract. Our financial performance also is affected by a number of other variables external to us and the petroleum industry, including political, economic and social conditions in China and foreign currency exchange fluctuations. For a further description of these factors and certain other factors affecting our financial performance, see "Item 3--Key Information--Risk Factors." The Reorganization Overview. Prior to the October 1999 reorganization of CNOOC, we did not exist as a separate legal entity and our business and operations were conducted by CNOOC and its various affiliates. In connection with the reorganization, CNOOC's oil and gas exploration, development, production and sales business and operations conducted both inside and outside China were transferred to us and our subsidiaries. As CNOOC controlled the business and operations transferred to us before the reorganization and continues to control us after the reorganization, the accompanying consolidated financial statements have been prepared on the basis of a reorganization under common control. Accordingly, the transfer of the business and operations has been accounted for in a manner similar to a pooling of interests. The accompanying consolidated balance sheets have been prepared to present our assets and liabilities as if the reorganization had been completed as of the beginning of the periods presented. The assets acquired by us and 63 the liabilities assumed by us have been stated at historical amounts. The accompanying consolidated statements of income and cash flows include our results of operations and cash flows as if the business and operations had been transferred to us at the beginning of the periods presented. In preparing the consolidated financial statements, those assets, liabilities, revenues and expenses that are clearly applicable to the businesses and operations transferred to us are included in the consolidated financial statements. For those expenses for which the specific identification method was not practical, we allocated the relevant expenses on the basis described in note 2 to the consolidated financial statements. See "Item 7--Major Shareholders and Related Party Transactions" and notes 1 and 2 to the consolidated financial statements. Implementation of New Agreements. Before the reorganization, certain PRC subsidiaries of CNOOC provided various materials, utilities and ancillary services for CNOOC's exploration and production of crude oil and natural gas. In September of 1999, in connection with our reorganization: o we entered into a new materials, utilities and ancillary services supply agreement under which the PRC subsidiaries of CNOOC that had previously provided such services agreed to continue to provide us with various materials, utilities and ancillary services. For the year ended December 31, 2001, our total cost for these materials, utilities and ancillary services was Rmb 1,103.6 million, compared to Rmb 618.1 million and Rmb 1,147.0 million for the years ended December 31, 1999 and 2000, respectively. o we and our subsidiaries entered into various lease agreements with other affiliates of CNOOC for various office and residential premises used in our business. Prior to the reorganization, the premises covered under the new lease agreements were owned by CNOOC and depreciated over their respective useful lives. Prior to the reorganization, China Offshore Oil Research Center, a subsidiary of CNOOC, provided general research and development services to CNOOC in connection with CNOOC's oil and gas business. o we entered into a new general research and development services agreement with China Offshore Oil Research Center for the provision of general geophysical exploration services, comprehensive exploration research services, information technology services and seismic study. Under this contract, we pay an annual amount of Rmb 110 million to China Offshore Oil Research Center. For the year ended December 31, 2001, our cost for these research and development services was Rmb 109 million, compared to Rmb 115 million and Rmb 104 million for the years ended December 31, 1999 and 2000, respectively. Prior to the reorganization, China Offshore Oil Research Center, a subsidiary of CNOOC, provided general research and development services to CNOOC in connection with CNOOC's oil and gas business. Our consolidated financial statements reflect the historical costs of these services prior to the effectiveness of the new agreements described above and the costs governed by these agreements for the periods after our October 1999 reorganization. For a description of these agreements, see "Item 7--Major Shareholders and Related Party Transactions." Revaluation of Assets. Under our reorganization, our real properties were revalued by an independent appraiser to reflect their fair market value. The revalued assets consist of certain land and properties but do not include our oil and gas properties. The revaluation would not be recorded under U.S. GAAP because real properties are generally required to be stated at their historical cost under U.S. GAAP. Furthermore, the effect on future depreciation expense under Hong Kong GAAP will be excluded from the determination of U.S. GAAP net income. 64 The Repsol Acquisition On January 18, 2002, we, through a wholly owned subsidiary, entered into a share purchase agreement to acquire nine subsidiaries of Repsol YPF, S.A., or the Repsol subsidiaries. The Repsol subsidiaries together hold a portfolio of operated and non-operated interests in oil and gas production sharing and technical assistance contracts in contract areas located offshore and onshore Indonesia. The assets to be acquired include a 65.3% interest in the South East Sumatra production sharing contract, a 36.7% interest in the Offshore Northwest Java production sharing contract, a 25.0% interest in the West Madura production sharing contract, a 50.0% interest in the Poleng technical assistance contract and a 16.7% interest in the Blora production sharing contract. On April 19, 2002, we announced the completion of the acquisition. The acquisition has effect from January 1, 2002. We expect to pay US$585.0 million and a US$6.86 million final oil price adjustment. Production Sharing Contracts We perform a significant amount of our oil and gas activities through production sharing contracts with international oil and gas companies. Under these production sharing contracts, our foreign partners are required to bear all exploration costs during the exploration period and such exploration costs can be recovered according to a production sharing formula after commercial discoveries are made and production begins. Our production sharing contracts provide us with the option to take a participating interest of up to 51% in properties covered by the production sharing contracts which we may exercise after the foreign partners have made viable commercial discoveries. The foreign partners retain the remaining participating interests. The development and operating costs are funded by us and the foreign partners according to our respective participating interests. Specified amounts of the annual gross production of petroleum from our producing fields subject to production sharing contracts are distributed in the following order: o to the PRC government for the payment of production taxes, o to the PRC government for the payment of royalties, o to the parties to recover operating costs incurred, o to the foreign partner to recover exploration costs, o to the parties to recover development costs plus interest according to the parties' respective participating interests, and o any remaining oil and gas, which is termed as "remainder oil," is first distributed to the PRC government at a pre-determined ratio, referred to as the government's "share oil," and then distributed to us and the foreign partners based on the respective participating interests. Before we exercise our option to take a participating interest of up to 51% in a production sharing contract, we do not account for the exploration costs incurred as these costs were incurred by our foreign partners. After we exercise the option to take a participating interest in a production sharing contract, we account for the oil and gas properties using the "proportional method" under which we recognize our share of development costs, revenues and expenses from such operations based on our participating interest in the production sharing contracts. We do not account for the exploration costs incurred by our foreign partners and their share of development costs and revenues and expenses from such operations. See note 4 to the consolidated financial statements. The foreign partners have the right either to take possession of their petroleum for sale in the international market or to sell their petroleum to us for resale in the PRC market. See "Item 4--Information on the Company--Production Sharing Contracts." For the years ended December 31, 1999, 2000 and 2001, certain of these foreign partners elected to sell approximately 78%, 53% and 57%, respectively, of their oil to us for resale in the PRC market. Their remaining portions were sold by them in international markets. Our foreign partners have complete discretion over whether they choose to sell their share of oil in China or in other international markets and the amount of their share of oil sold in China. Our decision to purchase our 65 foreign partners' share of oil is based on price negotiations with the applicable foreign partners and is not regulated in any way by the PRC government. The PRC government also does not restrict our foreign partners' ability to sell their share of oil to us. We do not know the specific reasons for the variations in the percentage of our foreign partners' oil sold to us for resale in the PRC as such selling decisions are business decisions made solely by our foreign partners. As described above, under our production sharing contracts, production of crude oil and natural gas is allocated among us, our foreign partners and the PRC government according to a formula contained in the contracts. Under this formula, a percentage of production under our production sharing contracts is allocated to the PRC government as its share oil. Share oil is not paid to the government in respect of our independent oil and gas production. Historically, the PRC government allowed CNOOC to retain the share oil as government contributions to its capital. Since our October 1999 reorganization, we have paid the share oil to CNOOC. In the future we may be required by the PRC government to make the share oil payments directly to the government. Accordingly, we have excluded the government's share oil from our net sales in our historical consolidated financial statements. Because our historical consolidated financial statements already exclude the government's share oil from our net sales, we do not expect any future share oil payments to affect our results of operations or operating cash flows differently than the effects reflected in our historical consolidated financial statements. For information regarding the historical amounts of government share oil payable to the government, see note 5 to the consolidated financial statements. We have participating interests of less than 100% in our oil and gas properties subject to production sharing contracts. We account for these properties using the "proportional method," in which our proportions, based on our participating interests, of the revenues and expenses from such operations are included in our consolidated statements of income. We have one associated company, Shanghai Petroleum and Natural Gas Company Limited, which owns the Pinghu field, and in which we own a 30% equity interest. Our equity interest in Shanghai Petroleum and Natural Gas Company Limited is accounted for using the equity method, under which our proportionate share of Shanghai Petroleum and Natural Gas Company Limited's net income or loss is included in our consolidated statements of income as share of income or loss of associated company. Our cost structures for production sharing contracts and for independent operations are different. The total expenses per unit of production under production sharing contracts are generally higher due to the use of expatriate staff of the foreign partners, administrative and overhead costs that may be allocated by the operators and a higher percentage of capital expenditures and equipment that are imported. Production from Independent Operations versus Production from Production Sharing Contracts Our net production arising from independent operations has increased steadily as compared to our net production arising from production sharing contracts since the beginning of 1997. The percentage of our total net production arising from independent operations was 42.1%, 50.6% and 56.7% for the years ended December 31, 1999, 2000 and 2001, respectively. This trend resulted primarily from our cooperation with foreign partners under production sharing contracts, which provides us with the expertise to exploit our independent operations more efficiently. As we become familiar with our foreign partners' technology and expertise, we are able to conduct independent operations that, in earlier periods, would have required a foreign partner under a production sharing contract to exploit fully. In future periods, we anticipate that this trend will continue. In addition, approximately US$970 million of our US$2.1 billion offshore China development budget through 2003 is planned for the development of independent properties. During the year ended December 31, 2001, 58.8% of our production came from properties operated by us. During the same period, only 41.2% of our production, or an estimated 37.3% of our revenues, came from properties operated by our foreign partners under production sharing contracts. Although we will continue to focus on independent operations, we plan to continue seeking appropriate opportunities to cooperate with foreign partners under production sharing contracts. Before we exercise our option to take a participating interest of up to 51% in a production sharing contract, we do not account for the exploration costs incurred as such costs were incurred by our foreign partners. After we exercise the option to take a participating interest in a production sharing contract, we account for the oil and gas properties using the "proportional method" under which we recognize our share of development costs, revenues and expenses from such operations based on our participating interest in the production sharing contracts. We do not 66 account for the exploration costs incurred by our foreign partners and their share of development costs and revenues and expenses from such operations. Impairment of Property, Plant and Equipment We incur charges for impairment of property, plant and equipment when recorded asset values are not expected to be recoverable through future cash flows. The charges are included in our consolidated statements of income under "Other" expenses. When assessing impairment of our oil and gas properties, we make the following assumptions and take into account the following factors to arrive at our estimated total cash flows: o We assume that production rates will remain constant for our producing wells unless and until we anticipate a decline in production ability. For this purpose, we consider only proved reserves. o We use test data and other related information to estimate the anticipated initial production rates for fields that are not currently producing. We then assume that these initial production rates will remain constant in the future. For proved reserves not yet on production, sales are estimated to commence at an anticipated date. o When we anticipate a decline in production ability for a field, we apply an estimated rate of decline for the depletion of the reserves at that field. We then apply this estimated rate of decline as the basis for estimating future production rates. o We assume that our prices for our oil and gas at December 31, 2001 will remain constant, except for known and determinable escalations, for purposes of our discounted cash flow calculation. For our year end data in our historical financial statements, we used the prevailing prices at December 31 of the applicable year. During the years ended December 31, 1999, 2000 and 2001, we did not have any forward sales. During the years ended December 31, 1999 and 2000, we did not incur any impairment charges. See note 3(s) to the consolidated financial statements. During the year 2001, we incurred an impairment charge of Rmb 99.7 million. Dismantlement and Site Restoration Allowance We estimate future dismantlement and site restoration costs for our oil and gas properties and accrue the costs over the economic lives of the assets using the unit-of-production method. The dismantlement and site restoration allowance for the years ended December 31, 1999, 2000 and 2001 was Rmb 177.1 million, Rmb 103.6 million and Rmb 90.4 million, respectively. The accrued liability is reflected in the company's consolidated balance sheet under "dismantlement and site restoration allowance." See note 22 to the consolidated financial statements. Production Imbalance We account for oil overlifts and underlifts using the entitlement method, under which overlifts are recorded as liabilities and underlifts are recorded as assets. An overlift occurs when we sell more than our percentage interest of oil from a property subject to a production sharing contract. An underlift occurs when we sell less than our participating interest of oil from a property under a production sharing contract. During the historical periods presented in our consolidated financial statements, we had no gas imbalances. We believe the production imbalance has no significant effects on our operations, liquidity or capital resources. Allowances for Doubtful Accounts 67 We evaluate our accounts receivable by considering the financial condition of our customers, their past payment history and credit standing and other specific factors, including whether the accounts receivable in question are under dispute. We make provisions for accounts receivable when they are overdue for six months and we are concerned about their collectibility, following an assessment using the above criteria. For the years ended December 31, 1999, 2000 and 2001, allowances for doubtful accounts were not material as compared to total operating expenses and did not have a material effect on our results of operations or financial condition. Results of Operations Overview The following table summarizes the components of our revenues and net production as percentages of our total revenues and total net production for the periods indicated: Year Ended December 31, ---------------------- 1999 2000 2001 ---- ---- ---- Revenues: (Rmb in millions, except percentages and production data) Oil and gas sales: Crude oil............................... 9,883 64.5% 17,189 71.0% 15,916 76.4% Natural gas............................ 1,515 9.9% 1,630 6.7% 1,645 7.9% ------ ------ ------ ------ ------ ------ Total oil and gas sales............. 11,398 74.4% 18,819 77.7% 17,561 84.3% Marketing revenues......................... 3,805 24.9% 5,126 21.2% 2,537 12.2% Other income............................... 108 0.7% 279 1.1% 722 3.5% ------ ------ ------ ------ ------ ------ Total revenues...................... 15,311 100.0% 24,224 100.0% 20,820 100.0% ====== ======= ======= ====== ====== ====== Net production (million BOE): Crude oil.............................. 63.8 83.7% 75.5 86.2% 83.5 87.5% Natural gas............................ 12.4 16.3% 12.1 13.8% 11.9 12.5% ------ ------ ------ ------ ------ ------ Total net production................ 76.2 100.0% 87.6 100.0% 95.4 100.0% ====== ====== ====== ====== ====== ====== The following table summarizes our oil and gas sales and net production by production sharing contracts and independent operations for the periods indicated: Year ended December 31, ---------------------- 1999 2000 2001 ---- ---- ---- (Rmb in millions, except percentages and production data) Oil and gas sales: Production sharing contracts................ 6,809 59.7% 9,536 50.7% 7,716 43.9% Independent operations...................... 4,589 40.3% 9,283 49.3% 9.845 56.1% ------ ------ ------ ------ ------ ------ Total oil and gas sales................ 11,398 100.0% 18,819 100.0% 17,561 100.0% ====== ====== ====== ====== ====== ====== Net production (million BOE): Production sharing contracts................ 44.1 57.9% 43.3 49.4% 40.2 42.1% Independent operations...................... 32.1 42.1% 44.3 50.6% 55.2 57.9% ------ ------ ------ ------ ------ ------ Total net production................... 76.2 100.0% 87.6 100.0% 95.4 100.0% ====== ====== ====== ====== ====== ====== For further information regarding the amounts of our revenues, assets and certain other financial items that are allocable to our production sharing contracts versus our independent operations, see note 32 to the consolidated financial statements. 68 The following table sets forth, for the periods indicated, certain income and expense items in our consolidated income statements as percentages of total revenues: Year ended December 31, 1999 2000 2001 ---- ---- ---- Revenues: Oil and gas sales.. 74.4% 77.7% 84.3% Marketing revenues.. 24.9 21.2 12.2 Other income.. 0.7 1.1 3.5 ------ ------ ------ Total revenues... 100.0% 100.0% 100.0% ====== ====== ====== Expenses: Operating expenses... (12.1)% (8.8)% (11.2%) Production taxes... (3.8) (4.3) (4.2) Exploration costs.. (1.6) (2.3) (5.0) Depreciation, depletion and amortization.......................... (15.5) (10.6) (12.3) Dismantlement and site restoration allowance....................... (1.2) (0.4) (0.4) Impairment losses related to property, plant and equipment......... -- -- (0.5) Crude oil and product purchases................................... (24.4) (21.0) (11.8) Selling and administrative expenses................................ (3.4) (1.9) (3.0) Interest, net... (3.7) (1.0) 1.0 Exchange (loss) gain, net... (2.8) 1.6 1.1 Other. -- (0.9) (2.5) ------ ------ ------ Total expenses.. (68.5)% (49.6)% (48.8%) ------ ------ ------ Share of profit of an associated company............................... 0.1 0.9 0.4 ------ ------ ------ Investment income.. -- -- 1.1 ------ ------ ------ Non-operating (loss) profit, net...................................... -- (0.8) 0.2 Income before tax... 31.6 50.5 52.9 Provision for taxation... (4.7) (8.0) (14.6) ------ ------ ------ Net income .... 26.9% 42.5% 38.3% ====== ====== ====== Calculation of Revenues In our consolidated financial statements, we report total revenues, which consist of oil and gas sales, marketing revenues and other income. Oil and gas sales represent gross oil and gas sales less royalties and share oil payable to the PRC government. Marketing revenues represent our sales of oil and gas that were produced under our production sharing contracts and purchased by us from the foreign partners under such contracts as well as revenues from the trading activities of our wholly owned Singapore subsidiary. These amounts are calculated as follows: o gross oil and gas sales consist of our percentage interest in total oil and gas sales, comprised of a 100% interest in our independent oil and gas properties and of our participating interest in the properties covered under our production sharing contracts, less an adjustment for production allocable to foreign partners under our production sharing contracts as reimbursement for exploration expenses attributable to our participating interest, o royalties represent royalties we pay to the PRC government on production with respect to each of our oil and gas fields. The amount of the royalties is a varying percentage from 0% up to 12.5% based on the annual production of the relevant property. We pay royalties on oil and gas we produce independently and under production sharing contracts, o government share oil, which is only paid on oil and gas produced under production sharing contracts, is calculated as described under "--Overview--Production Sharing Contracts," o marketing revenues represent our sales of our foreign partners' oil and gas produced under our production sharing contracts and purchased by us from our foreign partners under such contracts as well as revenues from the trading of oil and gas purchased from international oil and gas companies through our wholly owned Singapore subsidiary. Our cost of purchasing oil and gas from our foreign 69 partners and from international oil and gas companies is included as an expense in the income statement in our consolidated financial statements. Our foreign partners have the right to either take possession of their oil and gas for sale in the international market or to sell their oil and gas to us for resale in the PRC market, o our share of the oil and gas sales of our associated company is not included in our revenues, but our share of the profit or loss of our associated company is included in our consolidated statements of income under "share of (loss) income of associated company," o we pay production taxes to the PRC government that are equal to 5% of oil and gas produced independently and under production sharing contracts. Until May 1, 2001, we paid an additional 0.5% local surcharge on the oil and gas produced independently. This surcharge no longer exists. Our oil and gas sales are not reduced by production taxes. Production taxes are included in our expenses under "production taxes;" and o other income mainly represents project management fees charged to our foreign partners and handling fees charged to end customers, which are recognized when the services are rendered. The following table sets forth, for the periods indicated, oil and gas sales, royalties and government share oil in our consolidated financial statements as percentages of gross sales. See note 5 to the consolidated financial statements. Year ended December 31, 1999 2000 2001 ---- ---- ---- Oil and gas sales................ 89.9% 86.5% 89.3% Royalties......................... 0.8 1.0 1.4 Government share................. 9.3 12.5 9.3 ------ ----- ------ Gross sales...................... 100.0% 100.0% 100.0% 2001 versus 2000 We had consolidated net income of Rmb 7,957.6 million (US$961.5 million) in 2001, a decrease of Rmb 2,339.0 million (US$282.6 million), or 22.7 %, from Rmb 10,296.6 million in 2000. The decrease primarily reflected drops in global crude oil prices and the change in the enterprise income tax rate. The preferential enterprise income tax rate enjoyed by our PRC subsidiary ceased to apply after 2000 and the applicable enterprise income tax rate was adjusted from the 15% preferential rate to the normal rate of 30% with effect from the year 2001. Oil and gas sales for the year 2001 were Rmb 17,560.8 million (US$2,121.7 million), a decrease of Rmb 1,258.5 million (US$152.1 million), or 6.7%, from Rmb 18,819.3 million in 2000. Due to lower oil prices, our oil and gas sales from properties already operating prior to 2001 decreased approximately Rmb 3,351.0 million (US$ 404.9 million), which was partially offset by approximately Rmb 2,093.0 million (US$ 252.9 million) in additional sales brought on by the commencement of operations at new oil and gas properties in 2001. Our average net realized crude oil price was US$23.34 per barrel in 2001, a decrease of US$4.87, or 17.3%, from US$28.21 per barrel in 2000, due to decreases in international oil prices. Our average net realized natural gas price was US$3.08 per thousand cubic feet in 2001, essentially unchanged from US$3.09 per thousand cubic feet in 2000. Our natural gas prices are determined by negotiations between us and the buyers based on market conditions, typically with provisions for annual resets and adjustments which depend on a basket of crude oil prices, inflation and various other factors. Our net crude oil and condensate production in 2001 averaged approximately 228,874 barrels per day, an increase of 22,572 barrels, or 10.9% compared to 206,347 barrels per day in 2000. The increase in production primarily resulted from the commencement of production at new oil properties during 2001, including Suizhong 36-1 (phase II), Qikou 17-2 and Qinghuangdao 32-6. Our net natural gas production in 2001 averaged 195.0 million cubic feet per day, a decrease of approximately 2.9 million cubic feet, or 1.5%, from 197.9 million cubic feet per day in 2000. This decrease was primarily due to the increased thermal capacity of natural gas produced at Yacheng 13-1, which caused lower consumption of such natural gas by the contract user of Yacheng 13-1. 70 Other income, consisting primarily of project management fees and handling fees, was Rmb 721.7 million (US$87.2 million) in 2001, an increase of Rmb 443.1 million, or 159.0%, compared to Rmb 278.6 million in 2000. The increase in other income primarily resulted from increases in project management fees and handling fees for production sharing contract blocks. Operating expenses for the year 2001 were Rmb 2,329.1 million (US$281.4 million), an increase of Rmb 205.0 million (US$24.8 million), or 9.7%, from Rmb 2,124.1 million in 2000, primarily due to increased costs associated with the commencement of productions at new oil and gas properties. On a unit of production basis, our operating expenses in the year 2001 was Rmb 24.9 (US$3.01) per BOE, compared to Rmb 24.8 (US$2.99) per BOE in 2000. Production taxes for the year 2001 were Rmb 883.8 million (US$106.8 million), a decrease of Rmb 152.9 million (US$18.5 million), or 14.7%, from Rmb 1,036.7 million in 2000, The decrease was primarily due to lower sales revenue caused by significant drops in oil prices. Exploration costs for the year 2001 were Rmb 1,039.3 million (US$125.6 million), an increase of Rmb 486.4 million (US$58.8 million), or 88.0%, from Rmb 552.9 million in 2000 primarily due to the higher investment in significantly increasing exploration work in 2001 and the writing-off of expenses associated with exploration work on wells for uncertain reserves in earlier years. Our exploration costs relate principally to our independent exploration activities, as exploration costs under our production sharing contracts are funded by our foreign partners. Because we use the successful efforts method of accounting, our exploration costs do not include the costs of drilling and equipping successful wells. These amounts are capitalized and amortized on a unit of production basis. See note 3(f)(i) to the consolidated financial statements. Depreciation, depletion and amortization expense for the year 2001 was Rmb 2,566.9 million (US$310.1 million), a decrease of Rmb 11.0 million (US$1.4 million), or 0.4%, from Rmb 2,577.9 million in 2000. On a unit of production basis, depreciation, depletion and amortization expense for the year 2001 was Rmb 27.5 (US$3.32) per BOE, a decrease of Rmb 2.5 (US$0.30), or 8.3%, compared to Rmb 30.0 (US$3.63) per BOE in 2000. The primary reason for the decrease was that the increase in proven reserves in certain high-production oil & gas fields resulted in a decrease in the unit depreciation, depletion and amortization cost of those fields, thereby leading to the decrease in our total depreciation, depletion and amortization cost. Dismantlement and site restoration allowance for the year 2001 was Rmb 90.4 million (US$10.9 million), a decrease of Rmb 13.2 million (US$1.6 million), or 12.7%, from Rmb 103.6 million in 2000. The decrease was due to full provision of the allowance for certain mature fields in earlier years. Impairment losses related to oil and gas assets were Rmb 99.7 million (US$12.0 million), which reflected the estimated impairment resulting from two oil fields not being expected to fully recover their net book values through future cash flows. Marketing revenues for the year 2001 were Rmb 2,537.0 million (US$306.5 million), a decrease of Rmb 2,589.0 million (US$312.8 million), or 50.5%, from Rmb 5,126.0 million (US$619.3 million) in 2000. Crude oil and product purchases for the year 2001 were Rmb 2,453.3 million (US$296.4 million), a decrease of Rmb 2,644.5 million (US$319.5 million), or 51.9%, from Rmb 5,097.8 million in 2000. We handle crude oil sales in China for our foreign partners. Upon their request, we purchase their share of crude oil for resale in China, since we are one of the only three companies authorized to market and sell crude oil in the PRC. We do not have control over our foreign partners' decisions regarding the sale of their share of production, and therefore have no control over the volume that we may be asked to handle in any particular period. Selling and administrative expenses for the year 2001 were Rmb 615.4 million (US$74.4 million), an increase of Rmb 159.4 million (US$19.3 million), or 35.0%, from Rmb 456.0 million (US$55.1 million) in 2000. On a unit of production basis, selling and administrative expenses were Rmb 6.6 (US$0.80) per BOE in 2001, an increase of Rmb 1.3 (US$0.16), or 25% from Rmb 5.3 (US$0.64) per BOE in 2000. The relative increase resulted from a combination of the following factors: in 2000, selling and administrative expenses were lower in part due to the recovery of Rmb 57.7 million (US$7.0 million) in doubtful accounts; in 2001, we made a Rmb 40.0 million 71 provision for staff and workers bonus and welfare funds in accordance with a resolution of our board of directors, there was an increase of salary and staff benefits as a result of employee compensation reform; and there was also an increase of public facilities, office administrative, telecommunication and travelling expenses as a result of greater business volumes and higher office rents. We realized a net interest income of Rmb 201.1 million (US$24.3 million) for the year 2001, an increase of Rmb 439.5 million (US$53.1 million), or 184.4%, from a net interest expense of Rmb 238.4 million (US$28.8 million) in 2000. This increase was due to an increase in interest income resulting from significantly higher cash balances after our initial public offering in 2001 and lower interest expenses resulting from lower outstanding balances in respect of long-term indebtedness. We experienced an exchange gain of Rmb 235.4 million (US$28.4 million) for the year 2001, a decrease of Rmb 145.9 million (US$17.6 million) compared to Rmb 381.3 million (US$46.1 million) in 2000. The exchange gain or loss in each period mainly represents foreign exchange gains or losses on our Japanese yen denominated debt resulting from the depreciation or appreciation of Japanese yen against Renminbi. Other expenses for the year 2001 were Rmb 517.9 million (US$62.6 million), an increase of Rmb 300.3 million (US$36.3 million) from Rmb 217.6 million (US$26.3 million) in 2000, primarily due to the increase in expenses related to project management for production sharing contracts and the provision of services for areas covered by production sharing contracts. Investment income for 2001 was Rmb 220.7 million (US$26.7 million), which represented the income generated from investing the unused net proceeds from our initial public offering in low risk short term money market funds. Share of profit of associated company for the year 2001 was Rmb 90.0 million (US$10.9 million), a decrease of Rmb 128.3 million (US$15.5 million), or 58.8%, compared to a gain of Rmb 218.3 million (US$26.4 million) in 2000. This item reflected our share of profit generated by Shanghai Petroleum and Natural Gas Company Limited. This company experienced a decrease in profit in 2001 as compared to 2000 primarily due to an increase in its exploration costs and an increase in its amortization cost resulting from lower exploitable reserves, as well as a decline in 2001 in the realized price of its condensate. Non-operating profit for the year 2001 was Rmb 34.9 million (US$4.2 million), an increase of Rmb 230.9 million (US$27.9 million) from a non-operating loss of Rmb 196.0 million in 2000, primarily due to the losses incurred in the disposal of certain assets in 2000. Provision for taxation for the year 2001 was Rmb 3,048.2 million (US$368.3 million), an increase of Rmb 1,122.1 million (US$135.6 million), or 58.3%, from Rmb 1,926.1 million (US$232.7 million) in 2000. The primary reason for the increase was that the period for which our PRC subsidiary enjoyed preferential enterprise income tax treatment expired after 2000 and the applicable enterprise income tax rate for our PRC subsidiary was adjusted from 15% to the normal rate of 30% with effect from 2001. 2000 versus 1999 We had consolidated net income of Rmb 10,296.6 million (US$1,243.6 million) in 2000, an increase of Rmb 6,185.2million (US$747.1million), or 150.4 %, from Rmb 4,111.4 million in 1999. The increase primarily reflected increased oil prices, increased oil production volumes, continuing cost control measures and exchange gains on foreign currency denominated loans. Oil and gas sales for the year 2000 were Rmb 18,819.3 million (US$2,272.9million), an increase of Rmb 7,421.4 million (US$896.3 million), or 65.1%, from Rmb 11,397.9 million in 1999, primarily due to increased oil prices and increased oil production volumes. Our average net realized crude oil price was US$28.21 per barrel in 2000, an increase of US$9.3, or 49.2%, from US$18.91 per barrel in 1999, due to the increase in international oil prices. Our average net realized natural gas price was US$3.09 per thousand cubic feet in 2000, an increase of US$0.21, or 7.3%, from US$2.88 per thousand cubic feet in 1999. Our natural gas prices are determined by negotiations between us and the buyers based on market conditions, typically with provisions for annual resets and 72 adjustments which depend on a basket of crude oil prices, inflation and various other factors. This increase in gas prices resulted primarily from increased production at fields servicing customers buying our gas under higher priced contracts. Our net crude oil production in 2000 averaged 206,347barrels per day, an increase of 31,597 barrels, or 18%, compared to 174,750 barrels per day in 1999. Our net natural gas production in 2000 averaged 198 million cubic feet, per day, a decrease of approximately 6.4 million cubic feet, or 3%, from 204.4 million cubic feet per day in 1999. Our net crude oil production increase primarily resulted from new production including from fields Weizhou 12-1, Jinzhou 9-3, Qikou 17-2 and Huizhou 26-1N, and a reduction in production under production sharing contracts allocated to reimbursement of exploration expenses of foreign partners in the Huizhou and Xijiang oil fields, the effects of which were partially offset by declines in production in some mature fields, including Lufeng 13-1, and shutdowns for repair and maintenance at Lufeng 22-1. Our net production from independently owned and operated fields in 2000 averaged 122,120 BOE per day, an increase of 34,120 BOE, or 39%, compared to 88,000 BOE per day in 1999. Our net production from fields covered by production sharing contracts in 2000 averaged 117,218 BOE per day, an decrease of 3,592 BOE, or 3 %, compared to 120,810 BOE per day in 1999. Other income, consisting primarily of project management fees and handling fees, was Rmb 278.6 million (US$33.6 million) in 2000, an increase of Rmb 170.3 million, or 157.2%, compared to Rmb 108.3 million in 1999. The increase in other income primarily resulted from income we received from contracts with our foreign partners under which we facilitate the provision of construction services for the foreign partners' facilities offshore China. Operating expenses for the year 2000 were Rmb 2,124.1 million (US$256.5million), an increase of Rmb 268.8 million (US$32.5 million), or 14.5%, from Rmb 1,855.3 million in 1999, primarily due to increase of new oil and gas properties commenced production in 2000 and prices of fuel, rental and services as well as increased well operating costs attributable to older crude oil producing properties. On a unit of production basis, our operating expenses increased in the year 2000 was Rmb 24.8 (US$2.99) per BOE maintaining the same level as of 1999. On a unit of production basis, operating expenses arising from independently owned and operated fields for the year 2000 were Rmb 21.3 (US$2.6) per BOE, an increase of Rmb 3.7 (US$0.45) per BOE, or 21%, compared to Rmb 17.6 in 1999. On a unit of production basis, operating expenses arising from fields covered by production sharing contracts for the year 2000 were Rmb 28.1 (US$3.4) per BOE, a decrease of Rmb 1.7(US$0.21) per BOE, or 5.7% compared to Rmb 29.9 in 1999 Production taxes for the year 2000 were Rmb 1,036.7 million (US$125.2 million), an increase of Rmb 457.8 million (US$55.3 million), or 79.1%, from Rmb 578.9 million in 1999, due to the increase in crude oil prices and crude oil production.

Exploration costs for the year 2000 were Rmb 552.9 million (US$66.8 million), an increase of Rmb 306.5 million (US$37.0 million), or 124.4%, from Rmb 246.4 million in 1999. Our exploration costs relate principally to our independent exploration activities, as exploration costs under our production sharing contracts are funded by our foreign partners. These costs in year 2000 consisted principally of dry hole costs and also geology and geophysical costs, which increased compared to the year 1999 due to a lower drilling success rate and higher exploration budget. Because we use the successful efforts method of accounting, our exploration costs do not include the costs of drilling and equipping successful wells. These amounts are capitalized and amortized on a unit of production basis. Depreciation, depletion and amortization expense for the year 2000 was Rmb 2577.9 million (US$311.3 million), an increase of Rmb 204.5 million (US$24.7 million), or 8.6%, from Rmb 2,373.4 million in 1999, primarily due to the growth in crude oil production. Depreciation, depletion and amortization expense per BOE was Rmb 30.0(US$3.63) a decrease of 3.5% from Rmb 31.8 per BOE in 1999. On a unit of production basis, depreciation, depletion and amortization expense arising from independently owned and operated fields for the year 2000 was Rmb 33.7(US$4.07), an increase of Rmb 7.3 (US$0.88), or 28%, compared to Rmb 26.4 in 1999. On a unit of production basis, depreciation, depletion and amortization expense arising from fields covered by production sharing contracts for the year 2000 was Rmb 26.4 (US$3.18), a decrease of Rmb 9.6 (US$1.16), or 27.0%, compared to Rmb 35.5 in 1999. Dismantlement and site restoration allowance for the year 2000 was Rmb 103.6 million (US$12.5 million), a decrease of Rmb 73.5 million (US$8.9 million), or 41.5%, from Rmb 177.1 million in 1999, due to full provision of a number of old fields in early years. 73 Crude oil and product purchases for the year 2000 were Rmb 5,097.8 million (US$615.7 million), an increase of Rmb 1,361.1 million (US$164.4 million), or 36.4%, from Rmb 3,736.7 million in 1999. We handle crude oil sales in China for our foreign partners. Upon their request, we purchase their share of crude oil for resale in China, since we are the only company authorized to market and resell our foreign partners' crude oil in the PRC. We do not have control over our foreign partners' decisions regarding the sale of their share of production, and therefore have no control over the volume that we may be asked to handle in any particular period. Selling and administrative expenses for the year 2000 were Rmb 456.0million (US$55.1million), a decrease of Rmb 60.5 million (US$7.3 million), or 11.7%, from Rmb 516.5 million in 1999. On a unit of production basis, selling and administrative expenses were Rmb 5.3 (US$0.64) per BOE, a decrease of 23.2% from Rmb 6.9 (US$0.83) per BOE in 1999. This decrease resulted primarily from increase of write-back of doubtful accounts. For additional information regarding our selling and administrative expenses, see note 8 to the consolidated financial statements. Net interest expense for the year 2000 was Rmb 238.4 million (US$28.8 million), a decrease of Rmb 329.6 million, or 58.0%, from Rmb 568.0 million in 1999. This decrease primarily resulted from the increase in interest income due to higher cash balances and lower interest expenses resulting from lower outstanding debts. See note 9 to the consolidated financial statements. We experienced an exchange gain of Rmb 381.3 million (US$46.1 million) for the year 2000, compared to a loss of Rmb 432.0 million in 1999. The foreign exchange gain in 2000 primarily represented exchange gains on our Japanese yen-denominated loans. The foreign exchange loss in 1999 primarily represented exchange losses on our Japanese yen-denominated loans. Other expenses for the year 2000 were Rmb 217.6 million (US$26.3 million), an increase of Rmb 212.2 million from Rmb 5.4 million in 1999, due to the increase of expenses related to project management and construction services for the foreign partner's activities in offshore China, and disposal of useless materials. Share of income of associated company for the year 2000 was Rmb 218.3 million (US$26.4 million), an increase of Rmb 204.7 million (US$24.7 million), or 1,539%, compared to a gain of Rmb 13.3 million in 1999. The increase resulted from our 30% share of increased earnings generated by Shanghai Petroleum and Natural Gas Company Limited, which increase resulted from the commencement of commercial natural gas production at the Pinghu field in May 1999. We have a 30% equity interest in Shanghai Petroleum and Natural Gas Company Limited. Non-operating loss for the year 2000 was Rmb 196.0 million (US$23.7 million), an increase of Rmb 195.1 million (US$23.7million) from non-operating profit of Rmb 0.9 million in 1999, primarily due to losses from our disposal of unnecessary equipment. Provision for taxation for the year 2000 was Rmb 1,926 million (US$232.6 million), an increase of Rmb 1204.2 million (US$145.4 million), or 116.8%, from Rmb 721.9 million in 1999, primarily due to an increase in taxable income. In both periods, our provision for taxation reflected a 50% reduction in PRC enterprise income taxes, which reduction expired on December 31, 2000. Accordingly, our future PRC enterprise income tax rate will be higher than the rate reflected in our historical financial statements included in this annual report. 74 B. LIQUIDITY AND CAPITAL RESOURCES The following table summarizes cash flows for the periods presented: Year ended December 31, ---------------------- 1999 2000 2001 ---- ----- ---- (Rmb in millions) Cash provided by (used for):

Operating activities... 8,171.8 14,429.7 14,025.0 Returns on investments and servicing of finance... (651.1) (4,391.4) (3,922.6) Taxation.. (197.5) (880.1) (2,611.5) Investing activities.. (4,442.1) (7,860.6) (11,366.4) Financing activities... (2,428.1) 620.1 7,472.6 --------- --------- ---------- Net increase in cash and cash equivalents............................... 453.0 1,917.7 3,597.1 Cash Provided by Operations Cash provided by operations in 2001 decreased Rmb 404.7 million (US$48.9 million), or 2.8%, to Rmb 14,025.0 million (US$1,694.5 million), from Rmb 14,429.7 million (US$1,743.4 million) in 2000. The decrease resulted from a decrease in profit before tax of Rmb 1,216.8 million (US$147.0 million), a decrease in net interest expenses of Rmb 439.5 million (US$53.1 million) and an increase in short-term investment gains of Rmb 220.7 million (US$26.7 million). The decrease in cash flow was partly offset by a non-cash write off of exploration dry hole expenses and disposal of fixed assets of Rmb 456.8 (US$55.2 million), non-cash impairment losses related to oil and gas assets of Rmb 99.7 million (US$12.0 million), a decrease in share of profit of an associated company of Rmb 128.3 million (US$15.5 million) and a decrease in unrealized foreign exchange gain of Rmb 62.9 million (US$7.6 million). In addition, our operating cash flow was favorably affected by a net decrease in working capital. The decrease in working capital resulted from an increase of Rmb 267.7 million (US$32.3 million) in accounts payable and accrued liabilities and a decrease of Rmb 314.9 million (US$38.0 million) in accounts receivable and other current assets. We had a working capital surplus of Rmb 15,638.5 million (US$1,889.5 million) in 2001, an increase of Rmb 14,934.3 million (US$1,804.4 million), compared to Rmb 704.2 million (US$85.1 million) in 2000 and a working capital deficit of Rmb 4,189.7 million in 1999. The increase mainly resulted from proceeds of Rmb 10,101.6 million (US$1,220.5 million) received from our initial public offering in February 2001, a decrease of Rmb 3,397.3 million (US$410.5 million) in dividends payable and a decrease of Rmb 1,657.0 million (US$200.2 million) in retirement funds payable to our parent company. This increase was partially offset by an increase of Rmb 404.8 million (US$48.9 million) in accounts payable and accrued liabilities, an increase of Rmb 234.3 million (US$28.3 million) in current portion of long term bank loans and a decrease of Rmb 274.5 million (US$33.2 million) in accounts receivable and other receivable amounts. Cash provided by operations in 2000 increased Rmb 6,257.9 million (US$756.1 million), or 76.6%, to Rmb 14,429.7 million (US$1,743.4 million), from Rmb 8,171.8 million (US$987.3 million) in 1999. The increase resulted primarily from an increase in income before tax of Rmb 7,389.3 million (US$892.8 million), an increase of unrealized exchange gain of Rmb 726.7 million (US$87.8 million), and an increase of depreciation, depletion and amortization of expense of Rmb 204.5 million (US$24.7 million) which was offset by a decrease in dismantlement and site restoration allowance of Rmb 73.5 million, and an increase in unreceived share of income of associated company of Rmb 205.0 million. 75 In addition, operating cash flow in 2000 was adversely affected by a net increase in working capital of Rmb 326.4 million (US$39.4 million). The increase in working capital resulted from a decrease in accounts payable and accrued liabilities of Rmb 1,433.9 million, and an increase in other current assets of Rmb 39.4 million, which was partially offset by a decrease in accounts receivable of Rmb 1,146.6 million. The increase of Rmb 4,893.9 million in net working capital from December 31, 1999 to December 31, 2000 mainly resulted from Rmb 3,769.7 million received from the issuance of new shares in 2000 through private placements and a decrease in short-term bank loans and current portion of long term bank loans of Rmb 2,071.8 million, as well as a decrease of accounts payable and accrued liabilities of Rmb 1,460.3 million. This was partially offset by a decrease in accounts receivable of Rmb 1,089.0 million and an increase in dividends payable of Rmb 2,532.0 million and taxes payable of Rmb 767.1 million. Cash provided by operations in 1999 increased Rmb 3,578.9 million (US$432.4 million), or 77.9%, to Rmb 8,171.8 million (US$987.3 million), from Rmb 4,592.9 million in 1998. The increase resulted primarily from an increase in income before tax of Rmb 2,989.5 million and an increase in depreciation, depletion and amortization expense of Rmb 419.0 million which was offset in part by a decrease in net foreign exchange loss of Rmb 59.9 million, and a decrease in dismantlement and site restoration allowance of Rmb 10.3 million. In addition, operating cash flow in 1999 was adversely affected by a net increase in working capital of Rmb 163.9 million. The increase in working capital resulted from an increase in current assets, including increases in accounts receivable of Rmb 1,928.5 million, increases in inventories and supplies of Rmb 124.7 million and increases in other current assets of Rmb 1.8 million, which were offset in part by an increase in accounts payable and accruals of Rmb 1,583.7 million and increases in other taxes payable of Rmb 307.3 million. Capital Expenditures and Investments In line with our use of the successful efforts method of accounting, total capital expenditures and investments exclude expenditures associated with unsuccessful exploration and expenditures for disposed oil fields. Our total capital expenditures were Rmb 4,342.6 million

(US$524.7 million) in 2001, a decrease of Rmb 61.4 million (US$7.4 million), or 1.4%, from Rmb 4,404 million (US$532.1 million) in 2000. The capital expenditures in 2001 included Rmb 311.5 million (US$37.6 million) for capitalized exploration activities and Rmb 4,013.1 million (US$484.9 million) for development activities. Our development expenditures in 2001 related principally to the development of Suizhong 36-1 (Phase II) and Qinhuangdao 32-6 in Bohai Bay and Wenchang 13-1, Wenchang 13-2 and Dongfang 1-1 in Western South China Sea. Our total capital expenditures were Rmb 4,404 million (US$532.1 million) in 2000, an increase of Rmb 334.3 million (US$40.4 million), or 8.2%, from Rmb 4,069.7 million (US$491.5 million) in 1999. Our capital expenditures in 2000 included Rmb 57.0 million for capitalized exploration activities and Rmb 4,176.3 million for development activities. Our 2000 development expenditures related principally to the development of fields including Suizhong 36-1 (Phase II), Qinhuangdao 32-6, Wenchang 13-1/13-2 and Qikou 17-2. Our total capital expenditures and investments were Rmb 4,069.7 million (US$491.5 million) in 1999, an increase of Rmb 493.8 million (US$59.6 million), or 13.8%, from Rmb 3,575.9 million in 1998. Our capital expenditures in 1999 consisted of Rmb 205.2 million for exploration activities and Rmb 3,822.0 million for development activities. Our 1999 development expenditures related principally to the development of the second phase of the Suizhong 36-1 field, as well as the development of the Jinzhou 9-3, Weizhou 12-1, Weizhou 11-4 East and Qinhuangdao 32-6 fields. Our budgeted total capital expenditures for general exploration and development activities for the two-year period from 2002 through 2003, including expenditures for the Repsol acquisition (See "--The Repsol Acquisition"), is approximately US$3.2 billion, of which approximately US$400 million is budgeted for general exploration activities offshore China, approximately US$2.1 billion is budgeted for development activities offshore China, approximately US$50 million is budgeted for development activities overseas and approximately US$600 million is budgeted for the Repsol acquisition. 76 The following table sets forth, for our key operating areas in the years indicated, our budgeted capital expenditures for 2002 and 2003: Year ended ---------- December 31, ----------- 2002 2003 ---- ---- (US$ millions) Operating Area: Bohai Bay Development.. 373 913 Exploration.. 44 20 Western South China Sea: Development.. 218 193 Exploration.. 112 96 East China Sea: Development.. 25 123 Exploration.. 27 60 East South China Sea: Development.. 133 146 Exploration.. 36 24 Overseas: Development.. 50 -- Acquisition.. 600 -- Total.. 1,618 1,575 In addition to the budgeted development and exploration expenditures relating to the oil and gas properties described above, we may make additional capital expenditures and investments in these periods consistent with our business strategy, including our natural gas strategy. For example, the above budgeted amounts do not include any investments we may make in the liquefied natural gas project located in Guangdong Province, other natural gas projects and overseas natural gas properties. See "Item 4--Information on the Company--Business Overview--Business Strategy." Our ability to maintain and grow our revenues, net income and cash flows depends upon continued capital spending. We adjust our capital expenditure and investment budget on an annual basis. Our capital expenditure plans are subject to a number of risks, contingencies and other factors, some of which are beyond our control. Therefore actual future capital expenditures and investments will likely be different from our current planned amounts, and such differences may be significant. See "Item 3--Key Information--Risk Factors." Financing Activities We had net cash inflows from financing activities of Rmb 7,472.6 million (US$902.9 million) in 2001. Net cash flows from financing activities in 2001 resulted primarily from Rmb 10,101.6 million (US$1,220.5 million) in proceeds from our initial public offering, including the exercise of the related over-allotment option, in early 2001 and short-term bank loans of Rmb 2,500 million (US$302.1 million), offset in part by cash outflows of Rmb 3,497.5 million (US$422.6 million) for repayment of bank loans and Rmb 1,657.0 million (US$200.2 million) for retirement fund payments to our parent company. We had net cash inflows from financing activities of Rmb 620.1 million (US$74.9 million) in 2000. Net cash inflows in 2000 primarily resulted from net proceeds of Rmb 3,769.7 million (US$455.5 million) from the issuance of new shares to corporate investors in 2000, offset in part by cash outflows of Rmb 3,371.7 million (US$407.4 million) for repayment of bank loans. We had net cash outflows from financing activities of Rmb 2,428.1 million (US$293.4 million) in 1999. Net cash outflows in 1999 consisted of Rmb 2,143.9 million (US$259.0 million) for the repayment of bank loans, Rmb 471.6 million (US$57.0 million) for a withdrawal of capital investment by CNOOC and a Rmb 786.4 million (US$95.0 million) decrease in the amount payable to CNOOC. The return on capital investment to CNOOC in 1999 77 was due to the spin-off of certain assets unrelated to our petroleum exploration, development and production activities. Cash inflows from financing activities consisted of a Rmb 159.8 million (US$19.3 million) increase in the amount due to related companies and Rmb 814.0 million (US$98.3 million) in proceeds from bank loans. In addition to our capital expenditures and investments, we also have debt service obligations consisting of principal and interest payments on our outstanding indebtedness. The following table summarizes the maturities of our long-term debt outstanding as of December 31, 2001. Other than our guaranteed bond offering on March 8, 2002, there has been no material long-term debt incurred after December 31, 2001. Debt maturities principal only --- Original currency Total Rmb Total US$ --------------------- ----------- ----------- Due within December 31, US$ JPY Rmb equivalents equivalents --------------------- ------ ------ ---- ----------- ----------- (in millions) 2002 .... 103.4 5,190.7 49.0 1,231.8 148.8 2003-2005.. 38.9 13,511.5 567.3 1,740.6 210.3 2006-2007.. 100.0 9,007.5 120.0 1,515.1 183.1 Total... 242.3 27,709.7 736.3 4,487.5 542.2 After our initial public offering on February 22, 2001, we paid Rmb 1,660.0 million (US$200.6 million) to CNOOC in respect of employee retirement benefits due to retired CNOOC employees with proceeds from the initial public offering. See "--Employee Benefits." Prior to the October 1999 reorganization, the businesses transferred to us by CNOOC were funded by CNOOC. In connection with the reorganization, all of CNOOC's loans relating to the businesses were transferred to CNOOC China Limited, our wholly owned PRC subsidiary, and this debt is reflected in our financial statements included in this annual report. As of December 31, 2001, our total consolidated debt was Rmb 4,487.5 million (US$542.2 million), of which Rmb 1,231.8 million (US$148.8 million) was short-term debt, and Rmb 3,255.7 million (US$393.2 million) was long-term debt, excluding the current portion. Following the reorganization in October 1999, we paid dividends of Rmb 1,045.4 million (US$126.7 million) in March 2000 and declared a dividend of Rmb 6,426.4 million (US$776.5 million) on December 20, 2000, which was paid in full prior to February 1, 2001. On August 27, 2001, we declared a dividend of Rmb 871.8 million (US$105.3 million), which was paid in full prior to October 31, 2001. On March 27, 2002, our board of directors proposed a final dividend for 2001 of HK$1,232.1 (US$158.0 million). The proposed final dividend distribution is subject to our shareholders' approval in the next shareholders meeting. We intend to declare and pay dividends in the future. The payment and the amount of any dividends will depend on our results of operations, cash flows, financial condition, the payment by our subsidiaries of cash dividends to us, future prospects and other factors which our directors may consider relevant. Our distributions to CNOOC for the years ended December 31, 1999 and 2000 accounted for 43.4% and 62.4% of our net income for those years, respectively. Our distributions to CNOOC for the year ended December 31, 2001, including the year end dividend announced on March 27, 2002 that remains subject to approval by our shareholders, accounted for 19.3% of our net income. The amount of dividends we paid historically prior to becoming a public company in February 2001 is not indicative of the dividends we will pay in the future. We believe our future cash flows from operations, borrowing capacity and the proceeds from our initial public offering and guaranteed bond offering will be sufficient to fund planned capital expenditures and investments, debt maturities and working capital requirements through at least 2003. We have built good relationships and credibility with various international and PRC financial institutions. Several large financial institutions have expressed interest in supporting our business development, although we have not entered into any agreements for additional financing with them. However, our ability to obtain adequate financing to satisfy our capital expenditure and debt service requirements may be limited by our financial condition and results of operations and the liquidity of international and domestic financial markets including the following factors: 78 o Any failure by us to achieve timely rollover, extension or refinancing of its short-term debt may result in our inability to meet our obligations in connection with debt service, accounts payable and/or other liabilities when they become due and payable. o Our primary operating subsidiary is a PRC incorporated company. Therefore, prior to accessing international capital markets, we will be subject to limitations of various PRC government authorities, including the State Administration for Foreign Exchange and the People's Bank of China, depending on the type of international financing raised. We may also need to obtain PRC government support for any project involving significant capital investment in the operations of our PRC subsidiary. o In addition, financing sources often look to similarly situated entities when determining whether, and at what rates, to provide financing. Successful or unsuccessful financings by Hong Kong and PRC entities similarly situated to us could have an impact on our ability to obtain external financing. See "Item 3--Key Information--Risk Factors." Employee Benefits All of our full-time employees in the PRC are covered by a government-regulated pension plan and are entitled to an annual pension at their retirement dates. The PRC government is responsible for the pension liabilities to these retired employees under this government pension plan. The actual pension payable to each retiree is subject to a formula based on the status of the individual pension account, general salary and inflation movements. We are required to make annual contributions to the government pension plan at rates ranging from 9% to 22% of its employees' base salaries. The related pension costs are expensed as incurred. In addition to the government pension fund described above, CNOOC also provided a supplementary pension plan for its retirees, which was terminated on September 20, 1999 as a result of a general restructuring of our compensation scheme. The average annual supplementary pension payment was about Rmb 16,000 per retiree as of June 30, 1999. CNOOC retained all liabilities for retirement benefits for its employees, both former and current, who were not transferred to us under the reorganization. As compensation for CNOOC's retention of liabilities for retirement benefits payable under the terminated supplementary pension plan to approximately 7,000 retired CNOOC employees who were previously engaged in the oil and gas business that was transferred to us in the reorganization, we made a one-time payment to CNOOC of Rmb 1,660.0 million (US$200.6 million) in 2001. Our retirement expenses attributed to the current government plan in the respective historical periods are as follows: Year ended December 31, ------------------------ 1999 2000 2001 ---- ---- ---- Rmb Rmb Rmb (in millions) Expenses attributable to current government pension plan........................... 12.2 12.8 6.4 Costs related to the terminated supplementary pension were amortized over the service periods of the retirees. Approximately 1,600 employees retired in 1998 and no employees retired in 1999 prior to our October 1999 reorganization. As there were no retirees during 1999 prior to the reorganization, and as the supplementary pension plan was terminated prior to the reorganization, we did not attribute any expenses for the future payment of benefits under the supplementary pension during the year ended December 31, 1999. There were no expenses attributable to the terminated supplemental pension plan in 2000 and 2001. The expenses attributable to mandatory contributions under the current government pension plan are included in our historical consolidated statements of income under either operating expenses for our production staff or selling and administrative expenses for our administrative staff. The expenses attributable to employee retirement benefits reflected in our historical financial statements for periods prior to September 1999 were based on the current government pension plan as well as the supplementary pension plan that was terminated in September 1999. We expect that, under the current PRC rules and regulations regarding employee retirement benefits, the future costs 79 of the current government plan will be comparable to our historical costs subject to customary increases largely in line with salary increases of our employees. Holding Company Structure We are a holding company. Our entire petroleum exploration, development, production and sales business in the PRC is owned and conducted by CNOOC China Limited, our wholly foreign owned enterprise in the PRC. Our entire petroleum exploration, development and production business outside of the PRC is owned and conducted by CNOOC International Limited, our wholly owned subsidiary incorporated in the British Virgin Islands. International sales of crude oil are conducted by China Offshore Oil (Singapore) International Pte. Ltd., our wholly owned subsidiary incorporated in Singapore. Accordingly, our future cash flow will consist principally of dividends from our subsidiaries. The subsidiaries' ability to pay dividends to us is subject to various restrictions, including legal restrictions in the jurisdictions of incorporation of our subsidiaries. For example, legal restrictions in the PRC permit payment of dividends only out of net income determined in accordance with PRC accounting standards and regulations. In addition, under PRC law, CNOOC China Limited is required to set aside a portion of its net income each year to fund certain reserve funds. These reserves are not distributable as cash dividends. Deflation According to the China Statistical Bureau, China experienced an overall national deflation rate in 1999, 2000 and 2001, as represented by the general consumer price index, of 1.4%, 0.4% and 0.7%, respectively. The deflation has not had a significant impact on our results of operations in recent years. U.S. GAAP Reconciliation Our consolidated financial statements are prepared in accordance with HK GAAP, which differ in certain material respects from U.S. GAAP. These differences relate primarily to the treatment of the dividend of Rmb 1,045.4 million (US$126.3 million) that was paid to CNOOC in March 2000, revaluation of properties and land use rights performed in connection with the reorganization, the treatment of impairment of long-lived assets, the treatment of stock compensation plans and the treatment of unrealized holding gains from available-for-sale investments in marketable securities. Except for the accounting treatment of the property revaluation and the recognition of stock compensation costs and the unrealized holding gains from available-for-sale investments in marketable securities, there are no material differences between HK GAAP and U.S. GAAP that affect our net income or shareholders' equity. The difference in accounting treatment of dividend has been removed since January 1, 2001 with HK SSAP 9 coming into effect on that day. See note 36 to the consolidated financial statements. Taxation We are subject to income taxes on an entity basis on income arising in or derived from the tax jurisdiction in which we and each of our subsidiaries are domiciled and operate. We are not liable for income taxes in Hong Kong as we currently do not have any assessable income from Hong Kong sources. Pursuant to a notice issued by the State Administration of Taxation in March 2001, we will be entitled to all tax benefits conferred by Chinese law to foreign invested enterprises. Our PRC subsidiary, absent exemptions, is subject to enterprise income tax at the rate of 33%. Following the October 1999 reorganization, our PRC subsidiary became a wholly foreign owned enterprise and accordingly was exempted from 3% local surcharges, reducing our enterprise income tax rate to the current rate of 30%. Moreover, entities now comprising our PRC subsidiary were exempted from enterprise income taxes for two years starting from the first year of profitable operation in 1996 and were entitled to a 50% reduction of enterprise income taxes for three years beginning in 1998 and ending on December 31, 2000. This tax exemption increased the company's earnings by Rmb 536.4 million and Rmb 1,920.7 million during the years ended December 31, 1999 and 2000, respectively. Starting from January 1, 2001, the PRC subsidiary is no longer entitled to the 50% reduction of PRC enterprise income tax and is currently subject to the 30% enterprise income tax rate. The PRC enterprise 80 income tax was levied based on taxable income including income from operations as well as other components of earnings, as determined in accordance with the generally accepted accounting principles in the PRC, or PRC GAAP. PRC GAAP differs from HK GAAP in certain aspects, including timing differences. Deferred taxation was calculated to account for the tax attributes of the timing differences between PRC GAAP and HK GAAP. Major timing differences include accelerated amortization allowances for oil and gas properties, which are offset in part by a dismantlement and site restoration allowance and a provision for impairment of property, plant and equipment and write-off of unsuccessful exploratory drillings. As of December 31, 2001, we had Rmb 1,763.6 million (US$213.1 million) in net deferred tax liabilities primarily due to these timing differences. See note 10 to the consolidated financial statements. Besides income taxes, our PRC subsidiary also pays certain other taxes, including: o production taxes equal to 5% of independent production and production under production sharing contracts and o business tax of 3% to 5% on other income. Market Risks Our primary market risk exposures are to fluctuations in oil and gas prices, exchange rates and interest rates. Commodity Price Risks We are exposed to fluctuations in prices of crude oil and natural gas, which are commodities whose prices are determined by reference to international market prices. International oil and gas prices are volatile and this volatility has a significant effect on our net sales and net income. We do not hedge market risk resulting from fluctuations in oil and gas prices. See "--Overview" and "Item 3--Key Information--Risk Factors." Foreign Exchange Risk Our foreign exchange exposure gives rise to market risk associated with exchange rate movements. We maintain our accounts in Renminbi and most of our revenues and expenses are denominated in Renminbi. We also have some U.S. dollar revenues from exports of oil and gas. In addition, although our domestic sales are denominated in Renminbi, our domestic oil and gas prices are quoted in U.S. dollars based on international U.S. dollar oil prices and are billed and paid in Renminbi based on the Rmb--U.S. dollar exchange rates prevailing at the time of billing. Accordingly, substantially all of our domestic sales are U.S. dollar "linked." We are exposed to foreign exchange risk related to our debt because a substantial portion of our loans are denominated in foreign currencies, principally U.S. dollars and Japanese yen. Our U.S. dollar denominated loans totaled the equivalent of Rmb 4,638.1 million (US$560.4 million), Rmb 2,613.4 million (US$315.8 million) and Rmb 2,005.4 million (US$242.3 million) at December 31, 1999, 2000 and 2001, respectively, representing 51.0%, 45.5% and 44.7%, respectively, of our total loans at those dates. In addition, our wholly owned subsidiary, CNOOC Finance (2002) Limited, recently completed an offering of an aggregate principal amount of US$500 million in notes due in 2012. These notes are unconditionally and irrevocably guaranteed by us. Our yen-denominated loans were JPY 40,739 million, JPY 32,900 million and JPY 27,709.7 million as of December 31, 1999, 2000 and 2001, respectively, representing 36.3%, 41.5% and 38.9% of the total outstanding loans, respectively. Due to the current stable Rmb exchange rate policy and the adequate foreign exchange reserve held by the PRC government, we think there will be no substantial risk of Rmb depreciation. On the other hand, our oil and gas prices are quoted in US Dollars based on international oil and gas prices, which can help us offset the foreign exchange risk of US Dollar capital expenditures. So there is actually no exchange risk of conversion Rmb to US Dollar for our company. As a result, the foreign exchange risk faced by our company is the yen-denominated loan risk primarily. 81 The company is consistently managing the yen liability dynamically under the principle of "just hedge, no speculations". Since April of 2000, 94% of the yen liability is under the exposure. We have entered into two U.S. dollar-Japanese yen currency swaps relating to a portion of our yen-denominated debt, one of which was unwound on March 31, 2000. The only existing cross currency swap occurred at the end of 1995, involving a yen-denominated loan drawn at the beginning of 1995. The swap price was 95 JPY/US$, while the drawing cost of the loan was 83.6 JPY/US$. As the yen depreciated by 15% in 2001 and we maintained 94% of our yen liability under the exposure, we realized a foreign exchange gain of US$28.4 million from this currency swap which, we believe, indicates successful management of our yen-denominated debt. In addition, we are exposed to foreign exchange risk related to our capital expenditures because a portion of our capital expenditures represent imported equipment that is purchased in foreign currencies, principally U.S. dollars. During the years ended December 31, 1999, 2000 and 2001, approximately 35%, 27% and 16%, respectively, of the company's capital expenditures were denominated in foreign currencies, principally in U.S. dollars. We believe that our U.S. dollar-denominated and U.S. dollar-linked revenues partially limit our foreign exchange risk. However, any depreciation in the value of the Renminbi versus the U.S. dollar or Japanese yen could adversely affect the results of operations and financial condition. This could include potential increases in the Renminbi cost to us of servicing our foreign currency debt and the amount of our foreign currency debt as expressed in Renminbi on our balance sheet. Any increase would result in a foreign exchange loss that would be reflected as a noncash expense on our income statement in the year it occurs, an increase in the interest expense on our foreign currency debt as expressed in Renminbi on our income statement, and an increase in the Renminbi cost to us of our foreign currency capital expenditures and other foreign currency expenditures. Interest Rate Risk We are also exposed to interest rate risk arising from our short-term and long-term loans. Upward fluctuations in interest rates increase the cost of new debt and the interest cost of outstanding floating rate borrowings. A substantial portion of our borrowings have floating interest rates which are determined by reference to the London Interbank Offered Rate ("LIBOR") or floating interest rates quoted by PRC banks. At the beginning of 2001, the total amounts of foreign currency denominated floating interest rate and fixed interest rate debt of our company were US$215.7 million and US$387.9 million respectively. These figures declined to US$142.3 million and US$310.9 million by the end of 2001 respectively, accounting for 31.4% and 68.6% of the total foreign currency denominated debt respectively. Of the foreign currency fixed interest rate debt, 67.8% is denominated in yen and 32.2% is denominated in US Dollars Our interest expense decreased Rmb 358.4 million (US$43.3 million), or 75.4%, to Rmb 116.6 million (US$14.1 million) in 2001, from Rmb 475.0 million (US$57.4 million) in 2000. Our interest expense due to floating interest rate debt decreased by approximately 60% during the same period as a result of the 11 interest rate cuts by the US Federal Reserve in 2001. We believe that we will not be subject to risks of interest rate hike, since our floating interest rate debt will be paid off in the next 1.5 years in line with the payment schedule. We have not swapped any fixed rate debt for floating rate debt because the interest on such debt has been capitalized and has an average weighted fixed interest rate of 5.66%, which we believe can be entirely supported by our oil and gas operations. We use interest rate swap transactions, from time to time, to adjust our interest rate exposure when considered appropriate, based on existing and anticipated market conditions. Our policy is to match the interest payments under the interest rate swap agreements to the interest rate obligations due under underlying loan agreements so that the interest rate swaps qualify for hedge accounting. Interest rate differentials are reflected as an adjustment to interest expense over the life of the swap agreement. Our interest rate swaps are entered into with major financial institutions, thereby minimizing the risk of credit loss. 82 For additional discussions of our market risks, see "Item 3--Key Information--Risk Factors." Recent Accounting Pronouncements United States SFAS No. 141 "Business Combinations" In June 2001, Statement of Financial Accounting Standards ("SFAS") No. 141 "Business Combinations" was released. This statement addresses financial accounting and reporting for business combinations and requires that the purchase method of accounting to be used for all business combinations initiated or with the acquisition date after June 30, 2001. The adoption of this statement is not expected to have a significant effect on our financial statements. SFAS No. 143 "Accounting for Asset Retirement Obligations" On August 15, 2001, SFAS No. 143 "Accounting for Asset Retirement Obligations" was released and will be effective for the fiscal years beginning after June 15, 2002. This statement requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived assets. Further, under this statement, the liability is discounted and accretion expense is recognized using the credit-adjusted risk-free interest rate in effect when the liability was initially recognized. According to the existing accounting policies adopted to prepare the financial statements, we estimate future dismantlement and site restoration costs for oil and gas properties with reference to the estimates provided from either internal or external engineers after taking into consideration the anticipated method of dismantlement and the extent of site restoration required in accordance with current legislation and industry practice. We provide for the future dismantlement and site restoration allowance using the unit of production method over the useful life of the related asset. Adoption of the statement will likely result in increase in both costs of assets and total liabilities. We are currently assessing these matters and have not yet determined whether or the extent to which they will affect the financial statements. SFAS No. 144 "Accounting for the Impairment or Disposal of Long-lived Assets" In August 2001, SFAS No. 144 "Accounting for the Impairment or Disposal of Long-lived Assets" was released and will be effective for the fiscal years beginning after December 15, 2001. This statement retains the requirements of SFAS No. 121 to (a) recognize an impairment loss only if the carrying amount of a long-lived asset is not recoverable from its undiscounted cash flows and (b) measure an impairment loss as the difference between the carrying amount and fair value of the asset. This statement requires that a long-lived asset to be abandoned, exchanged for a similar productive asset, or distributed to owners in a spinoff be considered held and used until it is disposed of. The accounting model for long-lived assets to be disposed of by sale is used for all long-lived assets, whether previously held and used or newly acquired. That accounting model retains the requirement of SFAS No. 121 to measure a long-lived asset classified as held for sale at the lower of its carrying amount or fair value less cost to sell and to cease depreciation. Therefore, discontinued operations are no longer measured on a net realizable value basis, and future operating losses are no longer recognized before they occur. The changes in this statement improve financial reporting by requiring that one accounting model be used for long-lived assets to be disposed of by sale, whether previously held and used or newly acquired, and by broadening the presentation of discontinued operations to include more disposal transactions. The adoption of this statement is not expected to have a significant effect on our financial statements. 83 Hong Kong In February 2000, the Hong Kong Society of Accountants (HKSA) issued Statement of Standard Accounting Practice 14 "Leases" revised (SSAP 14 (revised)). SSAP 14 (revised) is effective for accounting periods beginning on or after July 1, 2000 and is therefore required to be adopted by us for the year ending December 31, 2001. SSAP 14 (revised) introduces changes to the way in which finance leases and operating leases are distinguished, the basis for recognizing finance income for lessors under finance leases and disclosure requirements for both lessors and lessees. SSAP 14 (revised) is not expected to have a significant effect on our financial statements. In February 2000, the HKSA also issued SSAP 26 "Segmental Reporting" (SSAP 26). SSAP 26 is effective for accounting periods beginning on or after January 1, 2001 and is therefore required to be adopted by us for the year ending December 31, 2001. SSAP 26 requires certain disclosures regarding a company's business and geographical segments. As SSAP 26 is applicable to companies whose equity or debt securities are listed or are in the process of being listed, the issue of guaranteed notes by our subsidiary will require us to adopt SSAP 26. In August 2001, the HKSA issued Statement of Accounting Practice 26 "Segment reporting" revised (SSAP 26 (revised)). SSAP 26 (revised) introduces changes to the components of financial statements. The adoption of SSAP 26 is not expected to have a significant effect on our financial statements. In January 2001, the HKSA issued the following Statements of Standard Accounting Practice (SSAPs): o SSAP 9 (Events after the balance sheet date) (revised); o SSAP 28 (Provisions, contingent liabilities and contingent assets); o SSAP 29 (Intangible assets); o SSAP 30 (Business combinations); o SSAP 31 (Impairment of assets); and o SSAP 32 (Consolidated financial statements and accounting for investments in subsidiaries). The above SSAPs are effective for accounting periods beginning on or after January 1, 2001 and are therefore required to be adopted by us for the year ending December 31, 2001. SSAP 9 (revised) introduces significant changes to when dividends are recognized in the financial statements. Dividends proposed, approved or declared after the balance sheet date are required to be recorded in the period in which they are proposed, approved or declared under SSAP 9 (revised). Previously dividends proposed, approved or declared after the balance sheet date are recorded in the period to which they relate. The adoption of SSAP 9 (revised) may have an impact on our financial statements depending on when dividends are proposed, approved or declared. SSAP 28 clarifies the rules on when and how to recognize provisions, contingent liabilities and contingent assets and requires far greater disclosure than previously required. The adoption of SSAP 28 is not expected to have a significant effect on our financial statements. SSAP 29 prescribes accounting principles for the recognition of intangible assets not dealt with under other SSAPs. SSAP 29 required intangible assets to be recognized and amortized in financial statements to the extent that they are identifiable, controllable and future economic benefits can be foreseen. The adoption of SSAP 29 is not expected to have a significant effect on our financial statements. SSAP 30 introduces certain fundamental changes relating to accounting for the acquisition of net assets and operations of another enterprise and eliminates the previously allowed practice of charging goodwill directly to reserves. SSAP 30 is not expected to have a significant effect on our financial statements. SSAP 31 prescribes the accounting and disclosure for the impairment of assets and applies to property, plant and equipment other than investment properties, goodwill, intangible assets, and investments in subsidiaries, 84 associates and joint ventures. Although the principle of reducing carrying values if assets were impaired was generally accepted, SSAP 31 sets out a new methodology to be adopted consistently across the balance sheet for the non-current assets set out above for identifying if an asset is impaired and if so, by how much its carrying value should be reduced. The adoption of SSAP 31 is not expected to have a significant effect on our financial statements. SSAP 32 replaces the existing SSAP 7 (Group accounts) and introduces certain changes including the requirement for enterprises to use a wider control-based definition of a subsidiary, as compared to the Hong Kong Companies Ordinance in determining whether a parent-subsidiary relationship exists. The adoption of SSAP 32 is not expected to have a significant effect on our financial statements. In October 2001, the HKSA issued Statement of Standard Accounting Practice 33 "Discontinuing operations" (SSAP 33). SSAP 33 is effective for accounting periods beginning on or after January 1, 2002. Early adoption is encouraged but not required. SSAP 33 establishes principles for reporting information about discontinuing operations, thereby enhancing the ability of users of financial statements to make projections of an enterprise's cash flows, earnings-generating capacity, and financial position by segregating information about discontinuing operations from information about continuing operations. The adoption of SSAP 33 is not expected to have a significant effect on our financial statements. In December 2001, the HKSA issued Statements of Standard Accounting Practice 34 "Employee benefits" (SSAP 34). SSAP 34 is effective for accounting periods beginning on or after January 1, 2002. Earlier adoption is encouraged but not required. The objective of SSAP 34 is to prescribe the accounting and disclosure for employee benefits. SSAP 34 requires an enterprise to recognize a liability when an employee has provided service in exchange for employee benefits to be paid in the future, and an expense when the enterprise consumes the economic benefit arising from service provided by an employee in exchange for employee benefits. The adoption of SSAP 34 is not expected to have a significant effect on our financial statements. 85 ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES A. DIRECTORS AND SENIOR MANAGEMENT In accordance with Hong Kong law and our articles of association, CNOOC Limited's affairs are managed by our board of directors. The board of directors has nine members, including two independent non-executive directors. The current directors and officers of CNOOC Limited are: Age as of ---------- Name December 31, 2001 Positions ----- ----------------- --------- Liucheng Wei 55 Chairman of the Board of Directors and Chief Executive Officer Chengyu Fu 50 President, Director and Chief Operating Officer Longsheng Jiang 56 Director Shouwei Zhou 50 Director and Executive Vice President Han Luo 48 Director Kai Sum Tso 69 Non-executive Director Will Honeybourne 50 Non-executive Director Chak Kwong So 56 Independent Non-executive Director Sung Hong Chiu 55 Independent Non-executive Director Ke Ru 58 Executive Vice President Yunshi Cao 56 Senior Vice President, Company Secretary and General Counsel Mark Qiu 38 Senior Vice President and Chief Financial Officer Mengfei Wu 46 Senior Vice President Hua Yang 40 Senior Vice President Mr. Kai Sum Tso and Mr. Will Honeybourne, our non-executive directors were appointed in July 2000 and December 2001, respectively. Mr. Longsheng Jiang and Mr. Han Luo were appointed in December 2000. All other executive directors and independent non-executive directors were appointed in September 1999. We have a management team with extensive experience in the oil and gas industry. As a result of our cooperation with international oil and gas companies, our management team and staff have had the opportunity to work closely with our foreign partners both within and outside China. Such opportunities, in conjunction with our management exchange programs with foreign partners, have provided valuable training to our personnel in international management practices. A description of the business experience and present position of each director and executive officer is provided below. Executive Directors Liucheng Wei received a B.S. degree from China Petroleum Institute and a graduate degree in Business Administration from the Chinese Academy of Social Sciences. He is a senior economist and has over 30 years' experience in the oil industry in the PRC. He was appointed as Chairman of the Board of Directors and Chief Executive Officer of our company in September 1999. Mr. Wei is also the President of CNOOC, a position he has held since November 1998. From 1993 to 1998, he served as Vice President of CNOOC. He joined CNOOC in 1982. Chengyu Fu received a B.S. degree from Northeast Petroleum Institute in China and a master's degree in petroleum engineering from the University of Southern California in the United States. He has over 26 years' experience in the petroleum industry in the PRC. He was appointed as director and Chief Operating Officer of our company in September 1999 and as President in December 2000. He is in charge of day-to-day management and administrative matters. Mr. Fu is also a vice president of CNOOC. In 1999, Mr. Fu was the General Manager of 86 China Offshore Oil Eastern South China Sea Corporation, a subsidiary of CNOOC. From 1995 to

1999, he served as Vice President and General Manager of Xijiang Operations of Phillips China Inc. From 1994 to 1995, he served as Deputy General Manager of China Offshore Oil Eastern South China Sea Corporation. He joined CNOOC in 1982. Longsheng Jiang received a B.S. degree from Beijing Petroleum Institute in China. He has over 31 years' experience in the oil and gas industry in the PRC. He was appointed as director of our company in December 2000. From 1982 to 1994, Mr. Jiang served as chief engineer of China Offshore Oil Western South China Sea Corporation. From 1995 to 1998, he was the general manager of China Offshore Oil Southern Drilling Company. Mr. Jiang is a Vice President of CNOOC, a position he has held since 1998. He joined CNOOC in 1982. Shouwei Zhou received a B.S. degree from Southwest China Petroleum Institute and is a senior engineer. He was appointed as director and Executive Vice President of our company in September 1999 in charge of the management and operation of CNOOC China. Mr. Zhou is also a vice president of CNOOC. From 1994 to 1999, Mr. Zhou was the Deputy Manager of China Offshore Oil Bohai Production Company, a subsidiary of CNOOC, and has been the President of China Offshore Oil Bohai Corporation since 1999. He joined CNOOC in 1982. Han Luo received a doctor's degree from China Petroleum University. He has over 26 years' experience in the oil industry in the PRC. He was appointed as director of our company in December 2000. From 1993 to 1999, Mr. Luo served as Vice President of China Offshore Oil Eastern South China Sea Corporation and concurrently the chief representative of CNOOC in the CACT operating group, and Executive Vice President of China Offshore Oil East China Sea Corporation. In April 1999, he was the general manager of CNOOC China--Shanghai Branch. Mr. Luo is a vice president of CNOOC, a position he has held since 2000. He joined CNOOC in 1982. Non-executive Directors Kai Sum Tso is the Group Managing Director of Hongkong Electric Co., Ltd. He was appointed to the board of Hongkong Electric in 1985 and assumed the current office in 1997. Mr. Tso worked with the Hongkong Electric Group from 1966 to 1981, holding positions of a Chief Project Engineer of the Hongkong Electric Company Limited and of an Executive Director of Associated Technical Services Limited. He is also an executive director of Cheung Kong Infrastructure. He has extensive experience in property development and business in power generation. He holds a B.S. degree in Engineering from the University of Hong Kong and is also a Chartered Engineer. Will Honeybourne is currently Managing Director of First Reserve Corporation. He joined First Reserve in 1999 and is responsible for deal origination and investment structuring and monitoring, with a primary focus on service technology and international markets. He serves on the board of directors of various First Reserve portfolio companies, currently including Dresser Inc., CiDRA Corporation, Canadian Crude Separators, Inc., and Destiny Resource Services Corporation. Prior to joining First Reserve, Mr. Honeybourne served as Senior Vice President of Western Atlas International, an oilfield services company. Prior to Western Atlas, he served as President and Chief Executive Officer of Alberta-based Computalog and in various capacities with Baker Hughes, including Vice President and General Manager at INTEQ and President of EXLOG. Born in Great Britain and currently a citizen of the United States, Mr. Honeybourne holds a BSc. in Oil Technology from Imperial College, London University. Independent Non-executive Directors Chak Kwong So is the Chairman of the board of directors and chief executive of the MTR Corporation Limited. He has been a Non-Executive Director of The Hongkong and Shanghai Banking Corporation Limited since January 2000. Mr. So began his career with the Hong Kong government. He joined the private sector in 1978, serving in various posts in the securities, finance and property industries. Mr. So also served as Executive Director of the Hong Kong Trade Development Council from 1985 to 1992. Mr. So is the President of the Chartered Institute of Logistics and Transport. He is also a vice president of the International Association of Public Transport and is the chairman of its Asia-Pacific Division. He also serves on a number of other committees and organizations, including the Hong Kong/European Union Business Cooperation Committee, Independent Commission Against Corruption--Operations Review Committee, the Employers' Federation of Hong Kong, the Hong Kong Management Association and the Community Chest of Hong Kong. 87 Sung Hong Chiu received an LL.B. degree from the University of Sydney. He is admitted as a solicitor of the Supreme Court of New South Wales and the High Court of Australia. He has over 27 years' experience in legal practice and is a director of a listed company in Australia. Mr. Chiu is the founding member of the Board of Trustees of the Australian Nursing Home Foundation and served as the General Secretary of Australian Chinese Community Association of New South Wales. Company Secretary Yunshi Cao is the Company Secretary, the General Counsel and a Senior Vice President of the Company. He is also the General Counsel and the Director of the Legal Department of CNOOC, a position he has held since 1999. He joined CNOOC in 1982. Mr. Cao is a senior economist and licensed lawyer in the PRC. He has extensive experience in production sharing contracts and over 30 years experience in the oil industry. He received a B.S. degree from the China Petroleum Institute and studied law at the Law School of Columbia University. Senior

Management Ke Ru is the Executive Vice President of our company and is responsible for our offshore petroleum exploration. Mr. Ru is a geologist, graduated from China Petroleum Institute and was a Visiting Scholar at the University of Oklahoma. He has over 30 years' experience in exploration, geophysical and geological research in China. He joined CNOOC in 1982 and was President of the Research Institute of China Offshore Oil Western South China Sea Corporation and Chief Geologist of CNOOC. Yunshi Cao, Senior Vice President (please refer to Company Secretary). Mark Qiu is a Senior Vice President and Chief Financial Officer of our company. Prior to joining our company, Mr. Qiu worked at Salomon Smith Barney and last served as the Head of Oil and Gas Investment Banking Group Asia. Prior to that, Mr. Qiu served as a Vice President at ARCO China Inc., a subsidiary of Atlantic Richfield Corporation (ARCO) and later as a Corporate Federal Government Relations Director of ARCO in Washington D.C. He was a Sloan Fellow and received an MBA degree from Massachusetts Institute of Technology and a doctoral and master degree in Decision Sciences from University of Texas. Mr. Qiu joined CNOOC in 2001. Mengfei Wu is a Senior Vice President of our company. He is a senior economist and holds a master's degree of industrial economics from the Graduate Institute of China Petroleum Institute. He has over 10 years' experience in corporate finance. Mr. Wu joined CNOOC in 1988 and was Director of the Department of Planning and Treasury of CNOOC. Hua Yang is a Senior Vice President of our company and President of CNOOC International Limited. He is a senior engineer and is responsible for our overseas operations. He received his B.S. degree from China Petroleum Institute. He has over 10 years' experience in petroleum exploration and production. Mr. Yang joined CNOOC in 1982 and was Acting Director of the Overseas Department of CNOOC. B. COMPENSATION OF DIRECTORS AND OFFICERS Each of the executive directors entered into a service contract with us for a term of three years made effective as of February 28, 2001, the date on which our shares commenced trading on The Stock Exchange of Hong Kong Limited, subject to termination by either party by written notice given not less than three months prior to the expiration of the end of the initial term or any subsequent calendar month. Particulars of these contracts are in all material respects identical except as indicated below: o the annual salary for Mr. Liucheng Wei (the Chairman of the Board and Chief Executive Officer), Mr. Chengyu Fu (President and Chief Operating Officer) and Mr. Shouwei Zhou (Executive Vice President) during the initial three years shall be HK$2,480,000, HK$1,880,000 and HK$1,680,000, respectively, subject to an annual increase as determined by the board of directors not exceeding 15% of his then current salary; 88 o the Chairman of the Board and the other executive directors shall be entitled to a maximum annual paid leave of 30 days and 25 days, respectively; o each of the executive directors is entitled to the use of an apartment as his residence and the use of a car provided free by us together with certain other benefits and reimbursements; o the annual salary for each of the other executive directors during the initial three years shall be HK$388,000, subject to an annual increase as determined by the board of directors not exceeding 15% of his then current salary; and o we may, at our sole discretion, pay an executive director a bonus in such amount as the board of directors may determine in respect of each complete financial year during which his appointment subsists. The aggregate amount of salaries, housing allowances, other allowances and benefits in kind paid to our executive directors during the years ended December 31, 1999, 2000 and 2001 was approximately Rmb 1.7 million (US$0.21 million), Rmb 2.5 million (US$0.30 million) and Rmb 8.3 million (US$1.00 million) respectively, while the amount paid to our executive officers for the same periods was approximately Rmb 670,808 (US$81,049), Rmb 1,251,305 (US$151,186) and Rmb 5.2 million (US$0.63 million) respectively. Under our pension contribution plan for 2001, we set aside an aggregate amount of Rmb 0.21 million (US$0.025 million) and Rmb 0.36 million (US$0.043 million) for pension and similar benefits in kind for the executive directors and executive officers respectively. The executive directors and the executive officers contributed additional Rmb 51,400 (US$6,210) and Rmb 70,500 (US$8,518) respectively, to the pension contribution plan for 2001. For further details regarding employee compensation, see "Item 4--Information on the Company--Business Overview--Employees and Employee Benefits." For further details regarding share options granted to our directors, officers and other employees, see "--Share Ownership" below. C. BOARD PRACTICE Audit and other Committees The audit committee consists of two independent non-executive directors. Its primary duties are to review and supervise the financial reporting process and our internal control system. The compensation committee consists of two independent non-executive directors and one non-executive director. Its primary duties are to manage our share option schemes and to formulate our remuneration policy. International Advisory Board On October 29, 2001, we announced the establishment of an International Advisory Board with globally well-respected political figures and corporate leaders as members. The purpose of the International Advisory Board is to provide the management with strategic advice on world events and macro issues that may impact our development. Set forth below is information on the members of the International Advisory Board. Name Biographical Information ---- ----------------------- Henry A. Kissinger 56th Secretary of State of the United States and former Assistant to the President for National Security Affairs. Born in Germany in May, 1923, he received his Ph.D. degree from Harvard University in 1954. Simon Murray Former Executive Chairman of Asia Pacific for the Deutsche Bank Group. He was the founder of Davenham Investments, a project advisory company. He became the Group Managing Director of Hutchison Whampoa in 1984. He is currently a Director of a number of companies that include Hutchison Whampoa, Cheung Kong Holdings, Tommy Hilfiger in the USA and Vivendi Universal in France. 89 Edward S. Steinfeld Assistant professor at the MIT Sloan School of Management. He received both his undergraduate and doctoral training at Harvard University. A China specialist, he has conducted extensive firm-level research in China. Erwin Schurtenberger Former Ambassador of Switzerland to China, the Democratic People's Republic of Korea and the Republic of Mongolia. He has been an independent business advisor to various European multinationals, American groups and humanitarian aid organizations such as Credit Suisse Financial Services, Novartis and Bunge. He received a Ph.D. degree in Economics and was trained in political science and philosophy. Kenneth S. Courtis Managing Director of Goldman Sachs and Vice Chairman of Goldman Sachs Asia. Professor Courtis has won numerous prizes and distinctions for his research and is a valued advisor on international economic, financial and investment matters. He has published on major international economic, public policy, investment, and strategy issues and frequently appears as a commentator on television news programs. Prior to joining Goldman Sachs, he served as Chief Asia Economist and Strategy for Deutsche Bank. D. EMPLOYEES See "Item 4--Information on the Company--Business Overview--Employees and Employee Benefits." E. SHARE OWNERSHIP On February 4, 2001, we adopted a share option scheme for our senior management. Under this share option scheme, the compensation committee of our board of directors will from time to time propose for board approval the recipient of and number of shares underlying each option grant. Options granted under this scheme will be exercisable, in whole or in part, in accordance with the following vesting schedule: o one-third of the shares underlying the option shall vest on the first anniversary of the date of the grant; o one-third of the shares underlying the option shall vest on the second anniversary of the date of the grant; and o one-third of the shares underlying the option shall vest on the third anniversary of the date of the grant. The scheme provides for issuance of options exercisable for shares granted under the share option scheme and the pre-global offering share option scheme not exceeding 10% of the total number of the outstanding shares of the company, excluding shares issued upon exercise of options granted under the scheme. The price for a share payable by a participant upon the exercise of an option will be determined by our board of directors in its discretion at the grant date, as long as the price will not be less than a specified minimum. The minimum price will be the higher of: o the nominal value of a share; o the average closing price of the shares on the HKSE as stated in the HKSE's quotation sheets for the five trading days immediately preceding the date of grant of the option; and o the closing price of the shares on the HKSE as stated in the HKSE's quotation sheets on the date of grant of the option. On September 1, 2001, the amendments to the relevant provisions of the Listing Rules of The Stock Exchange of Hong Kong Limited regarding the requirements of share option schemes of a Hong Kong listed company came 90 into effect. A Hong Kong listed company must comply with the new provisions of the Listing Rules if it wishes to grant any options after September 1, 2001. We have proposed to amend our share option scheme to comply with the new Listing Rules requirements. A circular setting out the changes to the share option scheme will be sent to our shareholders. An extraordinary general meeting will be held in Hong Kong on June 6, 2002 immediately after the conclusion of our annual general meeting on the same date to consider and, if thought fit, approve the amendments to the share option scheme. Options granted prior to September 1, 2001 will be governed by the rules of the share option scheme adopted on February 4, 2001. The amendments to the share option scheme will not operate to affect adversely the terms of issue of the options which have been granted prior to September 1, 2001. No further options will be granted under the share option scheme adopted on February 4, 2001. Under the proposed amended share option scheme, our board of directors may, at their discretion, invite employees, including executive directors of us or any of our subsidiaries, to take up options to subscribe for shares. The maximum aggregate number of shares (including those that could be subscribed for under the pre-global offering share option scheme as described below) which may be granted shall not exceed 10% of our total issued share capital. The maximum number of shares which may be granted under the share option scheme to any individual in any 12 month period up to the next grant will not exceed 1% of our total issued share capital from time to time. As at December 31, 2001, options for ordinary shares which have been granted under the share option scheme were as follows: Closing Price of Shares on August 24, 2001 Exercise Price No. of Name of Grantee Position

Date of Grant (HK$) (HK$) Options Wei Liucheng Chairman & CEO August 27, 2001 7.30 6.16 500,000 Fu Chengyu Executive Director, August 27, 2001 7.30 6.16 350,000 President & COO Jiang Longsheng Executive Director August 27, 2001 7.30 6.16 230,000 Zhou Shouwei Executive Director & August 27, 2001 7.30 6.16 350,000 Executive Vice President Luo Han Executive Director August 27, 2001 7.30 6.16 230,000 Other Employees August 27, 2001 7.30 6.16 7,160,000 We have also adopted a pre-global offering share option scheme. Its principal terms are the same as the share option scheme in all material respects except that: o options for an aggregate of 4,620,000 shares have been granted to our senior management under the pre-global offering share option scheme; o the subscription price of a share in respect of any particular option granted under the pre-global offering share option scheme is HK$5.95; and o options granted under the pre-global offering scheme will be exercisable, in whole or in part, in accordance with the following vesting schedule: o 50% of the shares underlying the option shall vest 18 months after the date of the grant; and o 50% of the shares underlying the option shall vest 30 months after the date of the grant. 91 As at December 31, 2001, options for ordinary shares which have been granted under the pre-global offering share option scheme were as follows: Exercise Price Name of Grantee Position Date of Grant (HK$) No. of Options Wei Liucheng Chairman & CEO March 12, 2001 5.95 500,000 Fu Chengyu Executive Director, March 12, 2001 5.95 350,000 President & COO Jiang Longsheng Executive Director March 12, 2001 5.95 280,000 Zhou Shouwei Executive Director & March 12, 2001 5.95 280,000 Executive Vice President Luo Han Executive Director March 12, 2001 5.95 280,000 Other Employees March 12, 2001 5.95 2,930,000 As of December 31, 2001, none of our officers and directors owned 1% or more of our shares including the shares underlying the stock options granted as of that date. 92 ITEM 7. Major Shareholders and Related Party Transactions A. MAJOR SHAREHOLDERS The following table sets forth information regarding the ownership of our outstanding shares as of April 30, 2002. Number of Shares Owned Shareholder (in millions) Percentage ----------- ------------- ----------- CNOOC 5,800 70.61% B. RELATED PARTY TRANSACTIONS Overview CNOOC indirectly owns or controls an aggregate of 70.61% of our shares as of April 30, 2002. Accordingly, it is able to exercise all the rights of a controlling shareholder, including electing our directors and voting to amend our articles of association. Although CNOOC retains a controlling interest in our company, the management of our business is our directors' responsibility. Prior to the reorganization, which became effective as of October 1, 1999, CNOOC and its various subsidiaries and affiliates performed commercial and administrative functions. In connection with the reorganization, we have entered into or will enter into the following agreements with CNOOC: (a) Reorganization In September 1999, we entered into a reorganization agreement with CNOOC which includes mutual indemnities given by CNOOC and us under which CNOOC indemnifies us in relation to the period before the completion of the reorganization and we indemnify CNOOC in relation to the period after the completion of the reorganization against, among other things, any claims incurred in connection with or arising from the transfer of the assets in the reorganization and from breach of any provision of the reorganization agreement. Our indemnity, however, is limited to the total liabilities of approximately Rmb 14,926 million shown on the balance sheet as of the date immediately before the completion of the reorganization. (b) Contracts with foreign petroleum companies Immediately prior to the reorganization, CNOOC had 37 production sharing contracts and one geophysical exploration agreement with various international oil and gas companies. As part of the reorganization, and in preparation for the global offering, CNOOC has transferred or will transfer to us all of its rights and obligations under these contracts and future contracts, except those rights and obligations relating to CNOOC's administrative functions. However, CNOOC remains and will remain a party to the production sharing contracts, as required by existing laws and regulations. Following the global offering, we continue to deal with CNOOC with respect to the performance of the rights and obligations retained by CNOOC under the production sharing contracts. (c) Undertaking CNOOC provided various undertakings to us. For further details on these and other undertakings given to us by CNOOC, see "--Undertakings." (d) Trademark license agreement CNOOC and CNOOC's affiliate are the respective registered owners of two "CNOOC" trademarks. Under two non-exclusive license agreements entered into on September 9, 1999, we have obtained the right to use 93 the trademarks for a nominal consideration of Rmb 1,000 for each of the trademarks. The registration of the trademarks will expire on December 6, 2008 and April 20, 2009, respectively. Each of CNOOC and CNOOC's affiliate undertakes that so long as CNOOC is our controlling shareholder (as defined in the listing rules of the Hong Kong Stock Exchange), it will renew the registration of the trademarks to enable us to continue to use the trademarks without any additional payment. (e) Lease agreement in respect of Nanshan Terminal Under an agreement dated September 9, 1999, among CNOOC, CNOOC's affiliate and us, CNOOC and CNOOC's affiliate have granted us a right to use the land and buildings comprising the Nanshan Terminal, Yacheng 13-1 without any consideration payable to CNOOC or its affiliate by us for a term of 20 years. (f) Contribution towards pension benefits As of June 30, 1999, CNOOC had approximately 7,000 retired employees who previously were engaged in the oil and gas business that was transferred to us. Under the reorganization, CNOOC agreed to take up the ultimate pension liabilities of such employees in consideration of the payment of Rmb 1,660.0 million. Following the closing of the global offering, we made a one-time payment to CNOOC of approximately Rmb 1,660.0 million (US$200.0 million) in respect of retirement benefits payable to such employees. This liability was reflected in our consolidated balance sheet as of September 30, 2000. CNOOC retains all liabilities for retirement benefits to its former and current employees who were not transferred to us under the reorganization. (g) Provision of materials, utilities and ancillary services After the establishment of CNOOC, four PRC subsidiaries were formed to undertake the exploration and production of oil and natural gas businesses. In addition, their scope of business included the provision of various facilities and ancillary services such as the supply of materials for offshore oil and gas production, medical and employee welfare services, major equipment maintenance and repair work and the supply of water, electricity and heat. After the reorganization, these PRC subsidiaries of CNOOC no longer undertake the exploration and production of oil and natural gas businesses but continue to hold interests in various properties, including office buildings and warehouses, and provide facilities and ancillary services to our subsidiary, CNOOC China Limited, some of which may not be available from independent third parties or available on comparable terms. Currently, these PRC subsidiaries of CNOOC only provide facilities and ancillary services to us. CNOOC China Limited has entered into a materials, utilities and ancillary services supply agreement with each of the four PRC subsidiaries of CNOOC. Under this agreement, each of these four PRC subsidiaries will, for a term of three years from September 9, 1999, provide to CNOOC China Limited various materials, utilities and ancillary services, including: o materials for offshore oil and gas production (including cement, diesel oil, mud, fuels, barite and paint); o oil and gas production labor services; o warehousing and storage; o road transportation services; o telecommunication and network services; o wharf services; o construction services, including the construction of roads, piers, buildings, plants and embankment; o major equipment maintenance and repair works; o medical, child care and social welfare services; o water, electricity and heat supply; 94 o security and fire services; o technical training; o accommodation; o repair and maintenance of buildings; and o catering services. The materials, utilities and ancillary services will be provided at: o state-prescribed prices, or o where there is no state-prescribed price, market prices, including the local or national market prices or the prices at which CNOOC's affiliates previously provided the relevant materials, utilities and ancillary services to independent third parties, or o where neither of the prices mentioned above is applicable, the cost to CNOOC of providing the relevant materials, utilities and services, including the cost of sourcing or purchasing from third parties, plus a margin of not more than 5%, before any applicable taxes. The prices, volumes and other terms for the supply of materials, utilities and ancillary services will be reviewed by the parties annually. If any of the terms are to be amended, the parties will enter into a supplemental agreement no later than 60 days prior to the end of the financial year preceding the financial year in which such amendments are to take effect. If the parties fail to reach agreement by then, the existing terms of the supply agreement will continue to apply until the parties agree on the terms of the supplemental agreement. The historical costs of the materials, utilities and ancillary services provided to us during the financial years ended December 31, 1999, 2000 and 2001 were Rmb 618.1 million, Rmb 1,147 million and Rmb 1,103.6 million, respectively. (h) Technical services Since the establishment of CNOOC, a number of specialized companies have been formed by CNOOC to provide sub-contracting services for CNOOC's offshore oil and gas production activities. These specialized companies also provided services to the operators of oil and gas fields under the production sharing contracts through an open bidding process. In connection with the reorganization, CNOOC transferred to us the existing technical services agreement with the specialized companies. After the transfer, we may terminate any of these agreements by giving 30 days' written notice to the relevant company. We will continue to use the technical services provided by CNOOC, including: o offshore drilling, o ship tugging, oil tanker transportation and security services, o well survey, well logging, well cementation and other related technical services, o collection of geophysical data, ocean geological prospecting, and data processing, o platform fabrication service and maintenance, and o design, construction, installation and test of offshore and onshore production facilities. For the years ended December 31, 1999, 2000 and 2001, the charges for such technical services payable to these specialized companies were approximately Rmb 1,068 million, Rmb 1,607 million and Rmb 2,012 million, respectively. These costs were calculated in accordance with the local market prices. 95 We expect that our award of any future contract to CNOOC's affiliates for technical services will be made if, following an open bidding process, the terms and prices provided by

CNOOC's affiliates are more competitive than those of the other suppliers. In view of the fact that we and CNOOC's affiliates became separate independent entities after our global offering in February 2001, the prices for the provision of the technical services may be higher than the charges paid to CNOOC's affiliates prior to our global offering. (i) Research and development services Under the terms of a general research and development services agreement dated September 9, 1999, with CNOOC's affiliate, China Offshore Oil Research Center, we will pay the Center for a term of three years from September 9, 1999, an annual amount of Rmb 110 million, which is calculated on the basis of the operating expenses of the relevant CNOOC affiliates during the two years ended December 31, 1998, for the provision of the services, including: o geophysical exploration services, o seismic data processing, o comprehensive exploration research services, and o information technology services. We may terminate the agreement by giving three months' written notice to China Offshore Oil Research Center. The Center undertakes that the number of working hours by its senior, middle rank and junior staff on services provided to us under the agreement will not be less than 187,000, 215,000 and 150,000 hours per year, respectively, which is in line with the number of working hours spent by such staff during the two years ended December 31, 1998. After the first year, we may request downward adjustment in the light of our requirements. For the three years ended December 31, 1999, 2000 and 2001, the costs of these general research and development services were approximately Rmb 115 million, Rmb 104 million and Rmb 109 million, respectively, representing approximately 0.7%, 0.4% and 0.5%, respectively, of our total revenues. The costs in respect of the periods prior to September 9, 1999 were calculated in accordance with the internal pricing policies of CNOOC and formulated primarily on the basis of their costs for the periods presented. We may also use the research and development services provided by the China Offshore Oil Research Center for the provision of research and development services for particular projects through an open bidding process. For the three years ended December 31, 1999, 2000 and 2001, the costs of these research and development services were approximately Rmb 125 million, Rmb 130 million and Rmb 118 million, respectively, representing approximately 0.8%, 0.5% and 0.6%, respectively, of our total revenues. (j) Lease and property management agreements We have entered into lease agreements with CNOOC for various office and residential premises in China and Singapore with annual aggregate payment totaling approximately Rmb 55 million. (k) Sales of crude oil, condensate oil, and liquefied petroleum gas We may sell crude oil, condensate oil, and liquefied petroleum gas to CNOOC's affiliates which engage in the downstream petroleum business at the international market price on normal commercial terms. For the year ended December 31, 1999, the total amount, based on the market price, which we would have received from CNOOC's affiliates if this arrangement had been in place since January 1, 1999 would have been approximately Rmb 117 million (US$14.1 million), representing approximately 0.8% of our total revenues for such period. For the years ended December 31, 2000 and 2001, the total amounts were approximately Rmb 548 million (US$66.2 million) and Rmb 1,814 million (US$216.2 million), respectively, representing approximately 2.9% and 9% of total revenues for the respective periods. 96 The above transactions constitute our connected transactions under the listing rules of the Hong Kong Stock Exchange for so long as CNOOC remains our substantial shareholder. Under the listing rules of the Hong Kong Stock Exchange, we are required, subject to the nature and the value of the transactions, to disclose and to obtain prior approval of independent shareholders for each connected party transaction. In the opinion of the directors, including the independent non-executive directors, the above connected transactions referred to in paragraphs (g), (h), (i), (j), and (k) have been or will be entered into in our ordinary course of business and on normal commercial terms or on terms that are fair and reasonable so far as our shareholders are concerned and the connected transactions referred to in paragraphs (a), (b), (c), (d), (e) and (f) have been and will be entered into on terms that are fair and reasonable so far as our shareholders are concerned. Because we believe that full disclosure and prior approval of all of such connected transactions in full compliance with the listing rules would be impracticable and add additional administrative costs to us, we have applied to the Hong Kong Stock Exchange for waivers from certain requirements of the listing rules. The Hong Kong Stock Exchange has indicated that it will grant a waiver if: (A) in relation to the connected transactions referred to in paragraphs (a) to (f), the transactions, and the respective agreements (if any) governing such transactions, are on terms that are fair and reasonable so far as our shareholders are concerned, and in relation to the connected transactions referred to in paragraphs (g) to (k), the transactions, and the respective agreements (if any) governing such transactions, are: (i) entered into by us in our ordinary and usual course of business; (ii) either on normal commercial terms or, where there is no available comparison, on terms no less favorable than those available to independent third parties; and (iii) on terms that are fair and reasonable so far as our shareholders are concerned; (B) brief details of the transactions in each year including the date or period of the transaction, the parties thereto and a description of their connected relationship, a brief description of the transaction and the purpose of the transaction, the total consideration and the terms, and the nature and extent of the interest of the connected person in the transaction, are disclosed in our annual report and accounts for the relevant year; (C) our independent non-executive directors annually review the transactions and confirm, in our annual report and accounts for the year in question, that such transactions have been conducted in the manner stated in condition (A) above and, where applicable, within the limit stated in condition (E) below; (D) our auditors carry out review procedures annually on the transactions and confirm to our directors in writing that the transactions: (i) received the approval of our directors; (ii) have been entered into in accordance with the pricing policies set forth in our financial statements; and (iii) have been entered into in accordance with the terms of the agreement governing the transactions or, where there is no agreement, on terms that are not less favorable than terms available to independent third parties. For the purpose of the above review by our auditors, CNOOC has undertaken to us that it will provide the auditors with access to its accounting records; (E) the aggregate annual volume of transactions do not exceed the limits set out below: The transactions Annual cap on aggregate value of transactions ---------------- --- Materials, utilities and ancillary services 10% of our audited consolidated total revenues supply agreements in the immediate preceding financial year Technical services in respect of each of the years ending December 31, 2000, 2001 and 2002, Rmb 2,200 million, Rmb 3,800 million and Rmb 5,300 million, respectively 97 Research and development services for particular in respect of each of the years ending December projects 31, 2000, 2001 and 2002, Rmb 140 million, Rmb 150 million and Rmb 160 million, respectively Sales of crude oil, condensate oil and liquefied in respect of each of the years ending December petroleum gas 31, 2000, 2001 and 2002, 4%, 25% and 38%, respectively, of our audited consolidated total revenues in the immediate preceding financial year The transactions Amounts set out in the relevant agreement ---------------- --- General research and development services Rmb 110 million agreement Lease and management agreements Rmb 55 million and; (F) we undertake that if any of the terms of the agreements or transactions referred to above are altered, or if we enter into any new agreements with any connected persons (within the meaning of the listing rules) in the future, or if the limits stated in (E) above are exceeded, we will comply with the provisions of the listing rules dealing with connected transactions unless a separate waiver from the Hong Kong Stock Exchange has been obtained. (i) Other Transactions On August 27, 2001, CNOOC China Limited, entered into an agreement with CNOOC to acquire CNOOC's interest in a joint venture with China Petrochemical Corporation with respect to certain oil and gas fields in Xihu Trough for a total consideration of US$45.0 million in cash. Xihu Trough is located in the East China Sea, 400 kilometers east of Shanghai. We will be the operator of the property. The acquisition was negotiated on an arm's length basis and reflected normal commercial terms. Directors' Interests Our directors have no interest in any business which competes or might compete with our businesses. C. INTERESTS OF EXPERTS AND COUNSEL Not applicable. 98 ITEM 8. Financial Information A. CONSOLIDATED STATEMENTS AND OTHER FINANCIAL INFORMATION See pages F-1 to F-53 following Item 19. Legal Proceedings The Company is not a defendant in any material litigation, claim or arbitration, and we know of no pending or threatened proceeding which would have a material adverse effect on our financial condition. Dividend Distribution Policy We intend to declare and pay dividends in the future. The payment and the amount of any dividends will depend on our results of operations, cash flows, financial condition, the payment by our subsidiaries of cash dividends to us, future prospects and other factors which our directors may consider relevant. In addition, as our controlling shareholder, CNOOC will be able to influence our dividend policy. Holders of our shares will be entitled to receive such dividends declared by our board of directors pro rata according to the amounts paid up or credited as paid up on the shares. Subject to the factors described above, we currently intend to pursue a dividend policy consistent with other international oil and gas exploration and production companies. Based on current share prices and dividends of international oil and gas exploration and production companies, we currently intend to target an initial dividend yield of approximately 1%. Dividends may be paid only out of our distributable profits as permitted under Hong Kong law, which does not restrict the payment of dividends to nonresident holders of our securities. To the extent profits are distributed as dividends, such portion of profits will not be available to be reinvested in our operations. Holders of our ADSs will be entitled to receive dividends, subject to the terms of the deposit agreement, to the same extent as holders of our shares, less the fees and expenses payable under the deposit agreement. Cash dividends will be paid to the depositary in Hong Kong dollars and, will be converted by the depositary into U.S. dollars and paid to holders of ADSs. Stock dividends, if any, will be distributed to the depositary and will be distributed by the depositary, in the form of additional ADSs, to holders of the ADSs. Following the reorganization of

CNOOC and our establishment as a separate legal entity in October 1999, we paid dividends of Rmb 1,045.4 million (US$126.3 million) in March 2000 and declared a dividend of Rmb 6,426.4 million (US$776.4 million) on December 20, 2000, which was paid in full prior to February 1, 2001. On August 27, 2001, we declared a dividend of Rmb 871.8 million (US$105.3 million), which was paid in full prior to October 31, 2001. On March 27, 2002, our board of directors proposed a final dividend for 2001 of HK$0.15 per share, totaling HK$1,232.1 million (US$158.0 million). The proposed final dividend distribution is subject to our shareholders' approval in the next shareholders meeting. We have not declared or paid any other dividends. The amount of dividends we paid historically prior to our initial public offering is not indicative of the dividends that we will pay in the future. Substantially all our dividend payments result from dividends paid to us by CNOOC China Limited. CNOOC China Limited must follow the laws and regulations of the PRC and its articles of association in determining its dividends. As a wholly foreign owned enterprise in China, CNOOC China has to provide for a reserve fund and staff and workers' bonus and welfare fund, each of which is appropriated from net profit after taxation but before dividend distribution according to the prevailing accounting rules and regulations in the PRC. CNOOC China is required to allocate at least 10% of its net profit to the reserve fund until the balance of this fund has reached 50% of its registered capital. Appropriations to the staff and workers' bonus and welfare fund, which are determined at the discretion of CNOOC China's directors, are charged to expense as incurred in the consolidated financial statements, which were prepared under HK GAAP. None of CNOOC China's contributions to these statutory funds may be used for dividend purposes. For the years ended December 31, 1999, 2000 and 2001, CNOOC China Limited made the following appropriations to the statutory reserves: 99 For the year ended For the year ended For the year ended ------------------ ------------------ ------------------ December 31, 1999 December 31, 2000 December 31, 2001 ------------------ ------------------ ------------------ Percentage Rmb Percentage Rmb Percentage Rmb ---------- --- ---------- ----- ---------- ---- of Net Profits (in millions) of Net (in millions) of Net (in millions) -------------- ------------- ---------- -------------- ---------- ----------- Profits Profits ------- ------- Reserve fund 10% 100.9 10% 847.5 10% 587.0 Staff and workers' bonus and 5% 50.4 -- -- 0.7% 40.0 welfare fund Prior to our reorganization, CNOOC China was not required to make contributions to these reserve funds. Because the appropriations for these funds are determined annually by CNOOC China's board of directors based on year-end financial statements, there were no appropriations to these funds for the year ended December 31, 2000. B. SIGNIFICANT CHANGES On March 8, 2002, CNOOC Finance (2002) Limited, our wholly-owned subsidiary successfully issued 10-year global bonds in the aggregate principal amount of US$500 million with a coupon of 6.375%. The notes, fully guaranteed by us, were priced at 163 basis points over the benchmark 10-year U.S. Treasury (with a yield of 4.913%). The notes are rated Baa2 with positive outlook by Moody's Investors Service and BBB by Standard & Poor's Ratings Services. In the first quarter of 2002, we repaid Rmb 1,081.7 million (US$130.7 million) of our long-term debt, which included repayment of Rmb 771.7 million (US$93.2 million) in principal amount due and prepayment of Rmb 310 million (US$37.5 million). After consolidation of the bond offering and the repayment and prepayment, our long-term debt outstanding as of March 31, 2002 was Rmb 7,532.7 million (US$910.1 million). On April 19, 2002, we announced the completion of the acquisition of nine subsidiaries of Repsol YPF, S.A. for an aggregate consideration of US$591.86 million. The acquisition has effect from January 1, 2002. See "Item 4 - Information on the Company - Principal Oil and Gas Regions - Overseas Activity" and "Item 5 - Operating and Financial Review and Prospects - Operating Results - The Repsol Acquisition." 100 ITEM 9. THE OFFER AND LISTING Not applicable, except for Item 9.A.4 and Item 9.C. The following table sets forth, for the periods indicated, the high and low closing prices per H Share, as reported on the Stock Exchange of Hong Kong, and per ADS, as reported on the New York Stock Exchange. The Stock Exchange of Hong Kong The New York Stock Exchange ------------------------------ -------------------------- Period High Low High Low (HK$) (US$) 2001* 8.70 6.00 22.00 15.70 2001 Financial Quarters 1st Quarter*............ 7.30 6.80 18.48 15.70 2nd Quarter............. 8.70 6.20 22.00 16.00 3rd Quarter............. 8.50 7.00 21.75 18.10 4th Quarter............. 8.15 6.90 20.70 17.35 Last six months November 2001........... 7.80 6.90 20.00 17.67 December 2001........... 7.65 6.90 19.69 17.35 January 2002............ 8.25 7.25 20.75 19.00 February 2002........... 9.00 7.85 22.70 20.05 March 2002.............. 9.95 8.20 25.10 21.39 April 2002............. 10.70 9.20 26.99 23.60 * We listed our ordinary shares on the Hong Kong Stock Exchange and our ADSs on the New York Stock Exchange in February 2001. 101 ITEM 10. ADDITIONAL INFORMATION A. SHARE CAPITAL Not applicable. B. MEMORANDUM AND ARTICLES OF ASSOCIATION Incorporated by reference to our registration statement on Form F-1 (Registration No. 333-10862), to which our articles of association was filed as an exhibit. C. MATERIAL CONTRACTS Incorporated by reference to our registration statement on Form F-1 (Registration No.

333-10862), to which our material contracts were filed as exhibits. For information regarding certain material contracts, see "Item 7.B - Major Shareholders and Related Party Transactions - Related Party Transactions." D. EXCHANGE CONTROLS We receive substantially all of our revenues in Renminbi. A portion of such revenues will need to be converted into other currencies to meet our foreign currency obligations. The level of foreign currency requirements is generally typical of our foreign currency needs and, based primarily on our current contractual commitments, we do not expect our cash flow requirements for foreign currency to increase materially in the near term. However, no assurances can be given that our needs will not increase significantly as many factors which determine our needs, such as exchange rates and imported crude oil prices, are not within our control. We have substantial requirements for foreign currency, including: o import of crude oil and other materials; o debt service on foreign currency denominated debt; o purchases of imported equipment; and o payment of any cash dividends declared in respect of the H shares. The existing foreign exchange regulations have significantly reduced government foreign exchange controls for transactions under the current account, including trade and service related foreign exchange transactions and payment of dividends. We may undertake current account foreign exchange transactions without prior approval from the State Administration of Foreign Exchange by producing commercial documents evidencing such transactions, provided that they are processed through Chinese banks licensed to engage in foreign exchange transactions. The PRC government has stated publicly that it intends to make the Renminbi freely convertible in the 102 future. However, we cannot predict whether the PRC government will continue its existing foreign exchange policy and when the PRC government will allow free conversion of Renminbi to foreign currency. Foreign exchange transactions under the capital account, including principal payments in respect of foreign currency-denominated obligations, continue to be subject to significant foreign exchange controls and require the approval of the State Administration of Foreign Exchange. These limitations could affect our ability to obtain foreign exchange through debt or equity financing, or to obtain foreign exchange for capital expenditures. Since 1994, the conversion of Renminbi into Hong Kong and United States dollars has been based on rates set by the People's Bank of China, which are set daily based on the previous day's PRC interbank foreign exchange market rate and current exchange rates on the world financial markets. Although the Renminbi to US dollar exchange rate has been relatively stable since 1994, we cannot predict nor give any assurance of its future stability. Fluctuations in exchange rates may adversely affect the value, translated or converted into US dollars or Hong Kong dollars, of our net assets, earnings and any declared dividends. We cannot give any assurance that any future movements in the exchange rate of the Renminbi against the US dollar and other foreign currencies will not adversely affect our results of operations and financial condition. We do not currently hedge exchange rate fluctuations between the Renminbi and the US dollar or other currencies and currently have no plans to do so. For further information on our foreign exchange risks, foreign exchange rates, our hedging activities and our historical foreign currency requirements, see "Currencies and Exchange Rates" and "Item 5--Operating and Financial Review and Prospects--Market Risks--Foreign Exchange Rate Risk." E. TAXATION The taxation of income and capital gains of holders of our shares or ADSs is subject to the laws and practices of Hong Kong and of jurisdictions in which holders of our shares or ADSs are resident or otherwise subject to tax. The following is a summary of taxation provisions that are anticipated to be material based on current law and practice, is subject to change and does not constitute legal or tax advice. The discussion does not deal with all possible tax consequences relating to an investment in our shares or ADSs. In particular, the discussion does not address the tax consequences under state, local and other laws, such as non-Hong Kong and non-U.S. federal laws. Accordingly, we urge you to consult your tax adviser regarding the tax consequences of an investment in our shares and ADSs. The discussion is based upon laws and relevant interpretations in effect as of the date of this annual report, all of which are subject to changes. There is no reciprocal tax treaty in effect between Hong Kong and the United States. Hong Kong Tax on Dividends Under the current practices of the Hong Kong Inland Revenue Department, no tax is payable in Hong Kong in connection with dividends paid by us. Profits Tax No tax is imposed in Hong Kong in respect of capital gains from the sale of property, such as the shares and ADSs. Trading gains from the sale of property by persons carrying on a trade, profession or business in Hong Kong where such gains are derived from or arise in Hong Kong from such trade, profession or business will be chargeable to Hong Kong profits tax which is currently imposed at the rate of 16% on corporations and at a maximum rate of 15% on individuals. Gains from sales of the shares effected on the Hong Kong Stock Exchange will be considered to be derived from or arise in Hong Kong. Liability for Hong Kong profits tax would thus arise in respect of trading gains from sales of shares or ADSs realized by persons carrying on a business of trading or dealing in securities in Hong Kong. Stamp Duty Hong Kong stamp duty, currently charged at the rate of HK$1.125 per HK$1,000 or part thereof on the higher of the consideration for or the value of the shares, will be payable by the purchaser on every purchase and by 103 the seller on every sale of shares. For example, a total of HK$2.25 per HK$1,000 or part thereof is currently payable on a typical sale and purchase transaction involving shares. In addition, a fixed duty of HK$5 is currently payable on any instrument of transfer of shares. The withdrawal of shares upon the surrender of ADRs, and the issuance of ADRs upon the deposit of shares, will also attract stamp duty at the rate described above for sale and purchase transactions unless the withdrawal or deposit does not result in a change in the beneficial ownership of the shares under Hong Kong law. The issuance of the ADRs upon the deposit of shares issued directly to the depositary or for the account of the depositary does not attract stamp duty. No Hong Kong stamp duty is payable upon the transfer of ADSs outside Hong Kong. Estate Duty The shares are Hong Kong property under Hong Kong law, and accordingly such shares may be subject to estate duty on the death of the beneficial owner of such shares, regardless of the place of the owner's residence, citizenship or domicile. We cannot assure you that the Hong Kong Inland Revenue Department will not treat the ADRs as Hong Kong property that may be subject to estate duty on the death of the beneficial owner of the ADR even if the ADRs are located outside Hong Kong at the date of such death. Hong Kong estate duty is imposed on a progressive scale from 5% to 15%. The rate of and the threshold for estate duty has, in the past, been adjusted on a fairly regular basis. No estate duty is payable when the aggregate value of the dutiable estate does not exceed HK$7.5 million, and the maximum rate of duty of 15% applies when the aggregate value of the dutiable estate exceeds HK$10.5 million. United States Federal Income Tax Considerations The following is a summary of United States federal income tax considerations that are anticipated to be material for U.S. Holders, as defined below. This summary is based upon existing United States federal income tax law, which is subject to change, possibly with retroactive effect. This summary does not discuss all aspects of United States federal income taxation which may be important to particular investors in light of their individual investment circumstances, such as investors subject to special tax rules including: partnerships, financial institutions, insurance companies, broker-dealers, tax-exempt organizations, and, except as described below, non-U.S. Holders, or to persons that will hold our shares or ADSs as part of a straddle, hedge, conversion, or constructive sale transaction for United States federal income tax purposes or that have a functional currency other than the United States dollar, all of whom may be subject to tax rules that differ significantly from those summarized below. In addition, this summary does not discuss any foreign, state, or local tax considerations. This summary assumes that investors will hold our shares or ADSs as "capital assets" (generally, property held for investment) under the United States Internal Revenue Code. Each prospective investor is urged to consult its tax advisor regarding the United States federal, state, local, and foreign income and other tax considerations of the purchase, ownership, and disposition of our shares or ADSs. For purposes of this summary, an U.S. Holder is a beneficial owner of shares or ADSs that is for United States federal income tax purposes: o an individual who is a citizen or resident of the United States; o a corporation, or other entity that is taxable as a corporation created in or organized under the laws of the United States or any State or political subdivision thereof; o an estate the income of which is includible in gross income for United States federal income tax purposes regardless of its source; o a trust the administration of which is subject to the primary supervision of a United States court and which has one or more United States persons who have the authority to control all substantial decisions of the trust; or o a trust that was in existence on August 20, 1996, was treated as a United States person, for United States federal income tax purposes, on the previous day, and elected to continue to be so treated. 104 A beneficial owner of our shares or ADSs that is not a U.S. Holder is referred to herein as a "Non-U.S. Holder." A foreign corporation will be treated as a "passive foreign investment company" (a "PFIC"), for United States federal income tax purposes, if 75% or more of its gross income consists of certain types of "passive" income or 50% or more of its assets are passive. Based on our current and projected income, assets, and activities, we presently believe that we are not a PFIC and do not anticipate becoming a PFIC. This is, however, a factual determination made on an annual basis. Because the classification of certain of our interests for United States federal income tax purposes is uncertain and the PFIC rules are subject to administrative interpretation, however, no assurance can be given that we are not or will not be treated as a PFIC. The discussion below under "U.S. Holders Dividends" and "U.S. Holders Sale or Other Disposition of Shares or ADSs", assumes that we will not be subject to treatment as a PFIC for United States federal income tax purposes. U.S. Holders For United States federal income tax purposes, a U.S. Holder of an ADS will be treated as the owner of the proportionate interest of the shares held by the depositary that is represented by an ADS and evidenced by such ADS. Accordingly, no gain or loss will be recognized upon the exchange of an ADS for the holders' proportionate interest in the shares. A U.S. Holder's tax basis in the withdrawn shares will be the same as the tax basis in the ADS surrendered therefore, and the holding period in the withdrawn shares will include the period during which the holder held the surrendered ADS. Dividends. Any cash distributions paid by us out of our earnings and profits, as determined under United States federal income tax principles, will be subject to tax as ordinary dividend income and will be includible in the gross income of a U.S. Holder upon receipt. Cash distributions paid by us in excess of our earnings and profits will be treated as a tax-free return of capital to the extent of the U.S. Holder's adjusted tax basis in our shares or ADSs, and after that as gain from the sale or exchange of a capital asset. Dividends paid in Hong Kong dollars will be includible in income in a United States dollar amount based on the United States dollar to Hong Kong dollar exchange rate prevailing at the time of receipt of such dividends by the depositary, in the case of ADSs, or by the U.S. Holder, in the case of shares held directly by such U.S. Holder. U.S. Holders should consult their tax advisors regarding the United States federal income tax treatment of any foreign currency gain or loss recognized on the subsequent conversion of Hong Kong dollars received as dividends to United States dollars. Dividends received on shares or ADSs will not be eligible for the dividends received deduction allowed to corporations. Dividends received on shares or ADSs will be treated, for United States federal income tax purposes, as foreign source income. A U.S. Holder may be eligible, subject to a number of complex limitations, to claim a foreign tax credit in respect of any foreign withholding taxes imposed on dividends received on shares or ADSs. U.S. Holders who do not elect to claim a foreign tax credit for federal income tax withheld may instead claim a deduction, for United States federal income tax purposes, in respect of such withholdings, but only for a year in which the U.S. Holder elects to do so for all creditable foreign income taxes. In addition, the United States Treasury has expressed concerns that parties to whom depositary shares are pre-released may be taking actions that are inconsistent with the claiming of foreign tax credits by the holders of ADSs. Accordingly, the analysis of the creditability of foreign withholding taxes could be affected by future actions that may be taken by the United States Treasury. Sale or Other Disposition of Shares or ADSs. A U.S. Holder will recognize capital gain or loss upon the sale or other disposition of shares or ADSs in an amount equal to the difference between the amount realized upon the disposition and the U.S. Holder's adjusted tax basis in such shares or ADSs, as each is determined in U.S. dollars. Any such capital gain or loss will be long-term if the shares or ADSs have been held for more than one year and will generally be United States source gain or loss. The claim of a deduction in respect of a capital loss, for United States federal income tax purposes, may be subject to limitations. If a U.S. Holder receives Hong Kong dollars for any such disposition, such U.S. Holder should consult its tax advisor regarding the United States federal income tax treatment of any foreign currency gain or loss recognized on the subsequent conversion of the Hong Kong dollars to United States dollars. 105 PFIC Considerations If we were to be classified as a PFIC in any taxable year, a U.S. Holder would be subject to special rules generally intended to reduce or eliminate any benefits from the deferral of United States federal income tax that a U.S. Holder could derive from investing in a foreign company that does not distribute all of its earnings on a current basis. In such event, a U.S. Holder of the shares or ADSs may be subject to tax at ordinary income tax rates on (i) any gain recognized on the sales of the shares or ADSs and (ii) any "excess distribution" paid on the shares or ADSs (generally, a distribution in excess of 125% of the average annual distributions paid by us in the three preceding taxable years). In addition, a U.S. Holder may be subject to an interest charge on such gain or excess distribution. Prospective investors are urged to consult their tax advisors regarding the potential tax consequences to them if we are or do become a PFIC, as well as certain elections that may be available to them to mitigate such consequences. Non-U.S. Holders An investment in shares or ADSs by a Non-U.S. Holder will not give rise to any United States federal income tax consequences unless: o the dividends received or gain recognized on the sale of the shares or ADSs by such person is treated as effectively connected with the conduct of a trade or business by such person in the United States as determined under United States federal income tax law, or o in the case of gains recognized on a sale of shares or ADSs by an individual, such individual is present in the United States for 183 days or more and certain other conditions are met. In order to avoid back-up withholding on dividend payments made in the United States, a Non-U.S. Holder of the shares or ADSs may be required to complete, and provide the payer with, an Internal Revenue Service Form W-8BEN, or other documentary evidence, certifying that such holder is an exempt foreign person. F. DIVIDENDS AND PAYING AGENTS Not applicable. G. STATEMENT BY EXPERTS Not applicable. H. DOCUMENTS ON DISPLAY We filed with the Securities and Exchange Commission in Washington, D.C. a Registration Statement on Form F-1 (Registration No. 333-10862) under the Securities Act in connection with the ADSs offered in the global offering. The Registration Statement contains exhibits and schedules. Any statement in this annual report about any of our contracts or other documents is not necessarily complete. If the contract or document is filed as an exhibit to the Registration Statement, the contract or document is deemed to modify the description contained in this annual report. You must review the exhibits themselves for a complete description of the contract or documents. You may inspect and copy our registration statements, including their exhibits and schedules, and the reports and other information we file with the Securities and Exchange Commission in accordance with the Exchange Act at the public reference facilities maintained by the Securities and Exchange Commission at Judiciary Plaza, 450 Fifth Street, Room 1024, N.W., Washington, D.C. 20549. You may also inspect the registration statements, including their exhibits and schedules, at the office of the New York Stock Exchange, Wall Street, New York, New York 10005. Copies of such material may also be obtained from the Public Reference Section of the Securities and Exchange Commission at 450 Fifth Street, N.W., Washington, D.C. 20549, at prescribed rates. You may obtain information regarding the Washington D.C. Public Reference Room by calling the Securities and Exchange Commission at 1-800-SEC-0330 or by contacting the Securities and Exchange Commission over the internet at its website at http://www.sec.gov. I. SUBSIDIARY INFORMATION Not applicable. 106 ITEM 11. QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK See "Item 5--Operating and Financial Review and Prospects--Market Risks." ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES Not applicable. 107 PART II ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES None. ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS A. MATERIAL MODIFICATIONS TO THE RIGHTS TO SECURITIES HOLDERS None. B. USE OF PROCEEDS As of March 31, 2002, we have used approximately Rmb 6,234.5 million (US$753.3 million) from the net offering proceeds of our initial public offering in February 2001 to fund our capital expenditures and investments and approximately Rmb 1,657 million (US$200.2 million) from the net offering proceeds to pay to CNOOC in respect of retirement benefits payable to retired CNOOC employees. The remainder of the proceeds was held in bank deposits in a separate account as of March 31, 2002, and will be applied to fund our capital expenditures and investment. None of the payments were direct or indirect payments to our directors, officers or affiliates. ITEM 15. RESERVED ITEM 16. RESERVED 108 PART III ITEM 17. FINANCIAL STATEMENTS Not applicable. ITEM 18. FINANCIAL STATEMENTS See pages F-1 to F-53 following Item 19. ITEM 19. EXHIBITS The following documents are filed as part of this annual report: 1.1 Articles of Association of the Registrant, incorporated by reference to Exhibit 3.1 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 1.2 Memorandum of Association of the Registrant, incorporated by reference to Exhibit 3.2 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.1 The Asset Swap Agreement dated July 20, 1999 between CNOOC and Offshore Oil Company Limited, incorporated by reference to Exhibit 10.1 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.2 The Asset Allocation Agreement dated July 20, 1999 between CNOOC and Offshore Oil Company Limited, incorporated by reference to Exhibit 10.2 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.3 The Reorganisation Agreement dated September 13, 1999 between CNOOC, Offshore Oil Company Limited and CNOOC Limited, incorporated by reference to Exhibit 10.3 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.4 Form of the Equity Transfer Agreement between CNOOC and CNOOC Limited, incorporated by reference to Exhibit 10.4 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.5 Form of the Transfer Agreement dated October 1, 1999 between CNOOC and Offshore Oil Company Limited regarding the transfer of the rights and obligations of CNOOC under the 37 production sharing contracts and one geophysical exploration agreement, incorporated by reference to Exhibit 10.5 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.6 Form of Equity Transfer Agreement between China Offshore Oil East China Sea Corporation and Offshore Oil Company Limited regarding the transfer of the rights and obligations under Joint Venture Contract of Shanghai Petroleum and Natural Gas Company Limited dated July 28, 1992 to Offshore Oil Company Limited, incorporated by reference to Exhibit 10.6 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.7 Transfer Agreement dated September 9, 1999 between CNOOC and Offshore Oil Company Limited regarding the transfer of the rights and obligations of CNOOC under the Natural Gas Sale and Purchase Contract dated December 22, 1992 to Offshore Oil Company Limited, incorporated by reference to Exhibit 10.7 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 109 4.8 Transfer Agreement dated September 9, 1999 between

CNOOC and Offshore Oil Company Limited regarding the transfer of the rights and obligations of CNOOC under the Natural Gas Sale and Purchase Contract dated November 7, 1992 to Offshore Oil Company Limited, incorporated by reference to Exhibit 10.8 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.9 Transfer Agreement dated September 9, 1999 among CNOOC, Offshore Oil Company Limited, the four PRC subsidiaries and CNOOC's affiliates regarding the transfer of the rights and obligations of the technical services agreements to Offshore Oil Company Limited, incorporated by reference to Exhibit 10.9 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.10 Nanshan Terminal Leasing Agreement dated September 9, 1999 between CNOOC, Hainan China Oil and Offshore Natural Gas Company and Offshore Oil Company Limited, incorporated by reference to Exhibit 10.10 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.11 Trademark Licence Agreement dated September 9, 1999 between CNOOC, Offshore Oil Company Limited and CNOOC Limited, incorporated by reference to Exhibit 10.11 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.12 Trademark Licence Agreement dated September 9, 1999 between China Offshore Oil Marketing Company, CNOOC Limited and Offshore Oil Company Limited and CNOOC Limited, incorporated by reference to Exhibit 10.12 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.13 Agreement for provision of materials, facilities and auxiliary services dated September 9, 1999 between China Offshore Oil Bohai Corporation and Offshore Oil Company Limited, incorporated by reference to Exhibit 10.13 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.14 Agreement for provision of materials, facilities and auxiliary services dated September 9, 1999 between China Offshore Oil Eastern South China Sea Corporation and Offshore Oil Company Limited, incorporated by reference to Exhibit 10.14 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.15 Agreement for provision of materials, facilities and auxiliary services dated September 9, 1999 between China Offshore Oil Western South China Sea Corporation and Offshore Oil Company Limited, incorporated by reference to Exhibit 10.15 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.16 Agreement for provision of materials, facilities and auxiliary services dated September 9, 1999 between China Offshore Oil East South China Sea Corporation and Offshore Oil Company Limited, incorporated by reference to Exhibit 10.16 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.17 General Research and Development Agreement dated September 9, 1999 between China Ocean Oil Research Institute and Offshore Oil Company Limited, incorporated by reference to Exhibit 10.17 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 110 4.18 Property Leasing Agreement dated September 9, 1999 between Wui Hai Enterprise Company Limited and Offshore Oil Company Limited in respect of the office premises at 6th, 7th and 8th Floors, CNOOC Plaza, No. 6 Dong Zhi Men Wai Xiao Jie, Beijing, incorporated by reference to Exhibit 10.18 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.19 Property Leasing Agreement dated September 9, 1999 between China Offshore Oil Western South China Sea Corporation and Offshore Oil Company Limited in respect of the office premises at 1st to 9th Floors, Nantiao Road, Potou District Zhangjiang, Guangdong, incorporated by reference to Exhibit 10.19 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.20 Property Leasing Agreement dated September 9, 1999 between China Offshore Oil Bohai Corporation and Offshore Oil Company Limited in respect of the office premises at 1st to 7th Floors and 9th Floor, 2-37 He Kou Jie, Tanggu District, Tianjin, incorporated by reference to Exhibit 10.20 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.21 Property Leasing Agreement dated September 9, 1999 between China Offshore Oil East China Sea Corporation and Offshore Oil Company Limited in respect of the office premises at 20th, 22nd and 23rd Floors, 583 Ling Ling Road, Shanghai, the PRC, incorporated by reference to Exhibit 10.21 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.22 Property Leasing Agreement dated September 9, 1999 between China Offshore Oil Eastern South China Sea Corporation and Offshore Oil Company Limited in respect of the office premises at 3rd Floor and 6th to 11th Floors, 1 Second Industrial Road, Shekou, Shenzhen, the PRC, incorporated by reference to Exhibit 10.22 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.23 Property Leasing Agreement dated September 9, 1999 between China

Offshore Oil Bohai Corporation and Offshore Oil Company Limited in respect of the Chengbei Warehouse, Chengbei Road, Tanggu District, Tianjin City, the PRC, incorporated by reference to Exhibit 10.23 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.24 Property Leasing Agreement dated September 9, 1999 between Overseas Oil & Gas Corporation Ltd. and China Offshore Oil (Singapore) International Pte. Ltd. in respect of the residential premises at 10-01 and 17-002 Aquamarine Tower, 50 Bayshore Road, 13-05 Jade Tower, 60 Bayshore Road, Singapore, incorporated by reference to Exhibit 10.24 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.25 Suizhong Pier Agreement dated September 9, 1999 between Offshore Oil Company Limited and China Offshore Bohai Corporation, incorporated by reference to Exhibit 10.25 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.26 Form of Novation Agreement among CNOOC, CNOOC China Limited, the Banks and other financial institution and the Fuji Bank Limited Hong Kong Branch, as agent, in respect of the transfer of the US$110 million syndicated loan, incorporated by reference to Exhibit 10.26 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 111 4.27 Form of the Undertaking Agreement between CNOOC and CNOOC Limited, incorporated by reference to Exhibit 10.27 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.28 Employment Contract between CNOOC Limited and Liucheng Wei (Service Agreement for Director, incorporated by reference to Exhibit 10.28 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.29 Employment Contract between CNOOC Limited and Chengyu Fu (Service Agreement for Director, incorporated by reference to Exhibit 10.29 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.30 Employment Contract between CNOOC Limited and Shouwei Zhou (Service Agreement for Director, incorporated by reference to Exhibit 10.30 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.31 Form of Pre-Global Offering Share Option Scheme for the Senior Management of CNOOC Limited, incorporated by reference to Exhibit 10.31 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.32 Form of Share Option Scheme for the Senior Management of CNOOC Limited, incorporated by reference to Exhibit 10.32 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.33 Subscription Agreement dated March 17, 2000 among CNOOC Limited, CNOOC (BVI) Limited, Overseas Oil & Gas Corporation, Ltd., et al., incorporated by reference to Exhibit 10.33 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.34 Subscription Agreement dated May 31, 2000 among CNOOC Limited, CNOOC (BVI) Limited, Overseas Oil & Gas Corporation, Ltd. and Hutchison International Limited, incorporated by reference to Exhibit 10.34 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.35 Subscription Agreement dated May 31, 2000 among CNOOC Limited, CNOOC (BVI) Limited, Overseas Oil & Gas Corporation, Ltd. and Hongkong Electric Holdings Limited, incorporated by reference to Exhibit 10.35 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.36 Subscription Agreement dated June 28, 2000 among CNOOC Limited, CNOOC (BVI) Limited, Overseas Oil & Gas Corporation, Ltd., et al., incorporated by reference to Exhibit 10.36 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.37 Corporation Placing Agreement dated February 6, 2001 among CNOOC Limited, China National Offshore Oil Corporation, Shell Eastern Petroleum (Pte) Limited and Merrill Lynch Far East Limited, incorporated by reference to Exhibit 10.37 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 8 List of Subsidiaries. 10 Letter from CNOOC Limited dated May 23, 2002 regarding receipt of certain representations from Arthur Andersen & Co. pursuant to the requirements of the United States Securities and Exchange Commission. 112 Signature The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report of its behalf. CNOOC Limited /s/ Cao Yunshi ------------------------- Name: Cao Yunshi Title: Company Secretary, General Counsel and Senior Vice President Date: May 23, 2002 CNOOC LIMITED AND ITS SUBSIDIARIES CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2001, 2000, AND 1999 TOGETHER WITH REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS INDEX TO FINANCIAL STATEMENTS Page CNOOC LIMITED AND ITS SUBSIDIARIES Report of Independent Public Accountants F-2 Consolidated statements of income for the years ended December 31, 2001, 2000, and 1999 F-3 Consolidated balance sheets as of December 31, 2001 and 2000 F-4 Consolidated statements of recognized gains and losses for the years ended December 31, 2001, 2000, and 1999 F-5 Consolidated statements of cash flows for the years ended December 31, 2001, 2000, and 1999 F-6 Notes to the consolidated financial statements F-7 F-1 REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS To the Shareholders of CNOOC Limited: We have audited the accompanying consolidated balance sheets of CNOOC Limited (established in the Hong Kong Special Administrative Region, the People's Republic of China) and its subsidiaries as of December 31, 2001 and 2000, and the related consolidated statements of income, recognized gains and losses and cash flows for the years ended December 31, 2001, 2000 and 1999. These financial statements are the responsibility of the management of CNOOC Limited. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with generally accepted auditing standards in the United States of America and auditing standards established by the Hong Kong Society of Accountants. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion. In our opinion, the accompanying consolidated financial statements referred to above present fairly, in all material respects, the financial positions of CNOOC Limited and its subsidiaries as of December 31, 2001 and 2000, and the results of their operations and cash flows for the years ended December 31, 2001, 2000 and 1999 in conformity with accounting principles generally accepted in Hong Kong ("Hong Kong GAAP"). Hong Kong GAAP does not conform to generally accepted accounting principles in the United States of America. A description of the significant differences between those two generally accepted accounting principles and the effect of those differences on net income and shareholders' equity is set forth in Note 36 to the consolidated financial statements. ARTHUR ANDERSEN & CO Certified Public Accountants Hong Kong March 27, 2002 F-2 CNOOC LIMITED AND ITS SUBSIDIARIES CONSOLIDATED STATEMENTS OF INCOME FOR THE YEARS ENDED DECEMBER 31, 2001, 2000, AND 1999 (All amounts expressed in thousands, except per share and per ADS data) Notes 1999 2000 2001 2001 ------- -------------- ------------- ------------- -------------- RMB'000 RMB'000 RMB'000 US$'000 Turnover Oil and gas sales 5, 27 11,397,873 18,819,323 17,560,788 2,121,739 Marketing revenues 6 3,804,367 5,126,015 2,537,032 306,531 Other income 108,347 278,580 721,737 87,202 -------------- ------------- ------------- -------------- 15,310,587 24,223,918 20,819,557 2,515,472 Total revenues -------------- ------------- ------------- -------------- Expenses Operating expenses 27 (1,855,309) (2,124,078) (2,329,130) (281,412) Production taxes 10 (578,878) (1,036,729) (883,768) (106,779) Exploration costs 27 (246,402) (552,869) (1,039,297) (125,571) Depreciation, depletion and amortization (2,373,380) (2,577,882) (2,566,920) (310,142) Dismantlement and site restoration allowance 22 (177,090) (103,569) (90,367) (10,918) Impairment losses related to property, plant and equipment - - (99,675) (12,043) Crude oil and product purchases 6 (3,736,671) (5,097,765) (2,453,312) (296,415) Selling and administrative expenses 8, 27 (516,485) (456,002) (615,389) (74,353) Interest, net 9, 27 (567,995) (238,380) 201,072 24,294 Exchange (loss) gain, net (431,980) 381,336 235,409 28,443 Other (5,423) (217,599) (517,876) (62,571) -------------- ------------- ------------- -------------- (10,489,613) (12,023,537) (10,159,253) (1,227,467) Total expenses -------------- ------------- ------------- -------------- Investment income 17 - - 220,650 26,659 -------------- ------------- ------------- -------------- Share of profit of an associated company 14 13,301 218,326 89,963 10,870 -------------- ------------- ------------- -------------- Non-operating (loss) income, net (911) (196,031) 34,941 4,222 -------------- ------------- ------------- -------------- Income before taxation 4,833,364 12,222,676 11,005,858 1,329,756 Provision for taxation 10 (721,925) (1,926,076) (3,048,227) (368,295) -------------- ------------- ------------- -------------- Net income 4,111,439 10,296,600 7,957,631 961,461 ============== ============= ============= ============== Net income per share, basic and diluted 12 RMB 0.69 RMB 1.63 RMB 1.00 US$ 0.12 ============== ============= ============= ============== Net income per ADS, basic and diluted 12 RMB 13.70 RMB 32.53 RMB 20.04 US$ 2.42 ============== ============= ============= ============== The accompanying notes are an integral part of these financial statements. F-3 CNOOC LIMITED AND ITS SUBSIDIARIES CONSOLIDATED BALANCE SHEETS AS OF DECEMBER 31, 2001 AND 2000 (All amounts expressed in thousands, except for share number and per share data) Notes 2000 2001 2001 ---------- ---------------- -------------- ---------------- ASSETS RMB'000 RMB'000 US$'000 Non-current assets Property, plant and equipment, net 13, 27 22,654,375 23,827,499 2,878,899 Investment in an associated company 14 471,027 461,990 55,819 ---------------- -------------- ---------------- 23,125,402 24,289,489 2,934,718 ---------------- -------------- ---------------- Current assets Cash and cash equivalents 2,796,627 6,393,724 772,506 Time deposits with maturities over three months 3,424,512 2,050,000 247,686 Short-term investments 17 300,000 8,895,804 1,074,814 Accounts receivable, net 15 1,916,190 1,194,180 144,284 Inventories and supplies 16 626,864 627,337 75,796 Due from related companies 21 162,688 176,519 21,327 Other current assets 245,122 692,595 83,682 ---------------- -------------- ---------------- 9,472,003 20,030,159 2,420,095 ---------------- -------------- ---------------- Total assets 32,597,405 44,319,648 5,354,813 ================ ============== ================ EQUITY AND LIABILITIES Capital and reserves Common stock, par value of HK$0.10 each, 15,000,000,000 shares authorized, 6,557,575,755 and 8,214,165,655 shares issued respectively 23 701,181 876,978 105,959 Reserves 25 15,420,622 32,433,528 3,918,702 ---------------- -------------- ---------------- 16,121,803 33,310,506 4,024,661 -------------------------------- ---------------- Non-current liabilities Long-term bank loans 18 4,748,844 3,255,699 393,362 Dismantlement and site restoration allowance 22 1,507,763 1,598,130 193,090 Deferred tax liabilities 10 1,451,220 1,763,637 213,087 -------------------------------- ---------------- 7,707,827 6,617,466 799,539 -------------------------------- ---------------- Current liabilities Current portion of long-term bank loans 18 997,533 1,231,840 148,834 Accounts payable 19 342,249 591,624 71,482 Other payables and accrued liabilities 20 657,656 813,146 98,245 Dividends payable 11 3,397,323 - - Due to parent company 21 1,782,497 125,493 15,162 Due to related companies 21 132,259 157,823 19,069 Taxes payable 1,458,258 1,471,750 177,821 -------------------------------- ---------------- 8,767,775 4,391,676 530,613 ---------------- -------------- ---------------- Total liabilities 16,475,602 11,009,142 1,330,152 ---------------- -------------- ---------------- Commitments and contingencies 28 Total equity and liabilities 32,597,405 44,319,648 5,354,813 ================ ============== ================ The accompanying notes are an integral part of these financial statements. F-4 CNOOC LIMITED AND ITS SUBSIDIARIES CONSOLIDATED STATEMENTS OF RECOGNIZED GAINS AND LOSSES FOR THE YEARS ENDED DECEMBER 31, 2001, 2000, AND 1999 (All amounts expressed in thousands) 1999 2000 2001 2001 ---------------- --------------- ---------------- ---------------- RMB'000 RMB'000 RMB'000 US$'000 Surplus on revaluation of properties 170,598 104,073 - - Exchange differences on translation of the financial statements of foreign entities - (6,350) 702 85 ---------------- --------------- ---------------- ---------------- Net gains not recognized in the income statement 170,598 97,723 702 85 Net income for the year 4,111,439 10,296,600 7,957,631 961,461 ---------------- --------------- ---------------- ---------------- Total recognized gains and losses 4,282,037 10,394,323 7,958,333 961,546 ================ =============== ================ ================ The accompanying notes are an integral part of these financial statements. F-5 CNOOC LIMITED AND ITS SUBSIDIARIES CONSOLIDATED CASH FLOW STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2001, 2000, AND 1999 (All amounts expressed in thousands) Notes 1999 2000 2001 2001 -------- -------------- -------------- -------------- --------------- RMB'000 RMB'000 RMB'000 US$'000 Net cash inflow from operating activities 31(a) 8,171,846 14,429,703 14,024,982 1,694,534 -------------- --------------- ---------------- --------------- Returns on investments and servicing of finance Interest received 53,709 163,461 317,706 38,386 Interest paid (704,826) (501,383) (124,422) (15,033) Short-term investment income received - - 53,641 6,481 Dividends received - 21,000 99,000 11,961 Dividends paid - (4,074,466) (4,268,517) (515,733) -------------- --------------- ---------------- --------------- (651,117) (4,391,388) (3,922,592) (473,938) -------------- --------------- ---------------- --------------- Taxation PRC income tax paid (182,056) (851,230) (2,584,451) (312,260) Overseas tax paid (15,454) (28,850) (26,999) (3,262) -------------- --------------- ---------------- --------------- (197,510) (880,080) (2,611,450) (315,522) -------------- --------------- ---------------- --------------- Investing activities Purchases of property, plant and equipment (4,069,690) (4,403,968) (4,342,622) (524,687) Proceeds from disposal of property, plant and equipment - 27,148 6,313 763 (Increase) Decrease in time deposits with maturities over three months - (3,424,512) 1,374,512 166,072 Additions of short-term investments - (300,000) (8,699,312) (1,051,073) Disposals of short-term investments - - 308,506 37,274 (Increase) Decrease in due from related companies (372,368) 240,726 (13,831) (1,671) -------------- --------------- ---------------- --------------- (4,442,058) (7,860,606) (11,366,434) (1,373,322) -------------- --------------- ---------------- --------------- Net cash inflow (outflow) before financing 2,881,161 1,297,629 (3,875,494) (468,248) -------------- --------------- ---------------- --------------- Financing 31(b) Proceeds from short-term bank loans 813,965 339,423 2,500,000 302,057 Repayment of bank loans (2,143,892) (3,371,657) (3,497,533) (422,581) Net proceeds from Private Placements - 3,769,664 - - Net proceeds from issue of ordinary shares - - 10,101,564 1,220,497 (Decrease) Increase in due to parent company (786,412) 47,256 (1,657,004) (200,203) Increase (Decrease) in due to related companies 159,844 (164,570) 25,564 3,088 Return of capital to CNOOC (471,560) - - - --------------- ---------------- ----------------- ---------------- (2,428,055) 620,116 7,472,591 902,858 --------------- ---------------- ----------------- ---------------- Net increase in cash and cash equivalents 453,106 1,917,745 3,597,097 434,610 Cash and cash equivalents, beginning of year 425,776 878,882 2,796,627 337,896 --------------- ---------------- ----------------- ---------------- Cash and cash equivalents, end of year 878,882 2,796,627 6,393,724 772,506 =============== ================ ================= ================ The accompanying notes are an integral part of these financial statements. F-6 CNOOC LIMITED AND ITS SUBSIDIARIES NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Amounts expressed in Renminbi unless otherwise stated) 1. ORGANIZATION AND PRINCIPAL ACTIVITIES CNOOC Limited ("We") was incorporated in the Hong Kong Special Administrative Region ("Hong Kong"), the People's Republic of China (the "PRC") on August 20, 1999 to hold the interests in the entities now comprising our subsidiaries. We and our subsidiaries are principally engaged in exploration, development, production and sales of crude oil, natural gas and other Petroleum. Prior to our formation, the businesses and operations were carried on by China National Offshore Oil Corporation ("CNOOC"). All such businesses and operations were transferred to us pursuant to a reorganization effective on October 1, 1999, in preparation for the public offering of our shares (the "Reorganization"). As a result of the Reorganization, CNOOC's interests in offshore oil and gas exploration, development, production and sales businesses in and outside of the PRC were transferred to us. CNOOC's assets and liabilities relating to such businesses in the PRC were transferred to our wholly owned subsidiary, CNOOC China Limited, a wholly foreign owned enterprise established in the PRC. CNOOC's interests in offshore oil and gas businesses outside of the PRC were transferred to our wholly owned subsidiaries, CNOOC International Limited, a company incorporated in the British Virgin Islands, and China Offshore Oil (Singapore) International Pte. Ltd., a company incorporated in Singapore. F-7 1. ORGANIZATION AND PRINCIPAL ACTIVITIES (CONT'D) As of December 31, 2001, we had direct or indirect interests in the following principal subsidiaries. All of these entities are private limited companies and were owned by CNOOC upon their incorporation/establishment except for CNOOC International Limited which was owned by us upon its incorporation: Percentage of Place and date of equity interest incorporation / attributable Issued and Name of entity establishment to us paid up capital Principal activities -------------------- --------------------- ------------------ ---------------- --------------------------- Directly held subsidiaries: CNOOC China Tianjin, the PRC 100% RMB10 billion Offshore petroleum Limited September 15, exploration, development, 1999 production and sales in the PRC CNOOC International British Virgin Islands 100% US$2 Investment holding Limited August 23, 1999 China Offshore Oil Singapore 100% S$3 million Sales and marketing of (Singapore) May 14, 1993 petroleum outside of the International PRC Pte. Ltd. Indirectly held subsidiaries*: Malacca Petroleum Bermuda 100% US$12,000 Investment holding Limited November 2, 1995 OOGC America, Inc. State of Delaware, 100% US$1,000 Investment holding United States of America September 2, 1997 OOGC Malacca Limited Bermuda 100% US$12,000 Investment holding November 2, 1995 CNOOC Southeast Asia Bermuda 100% US$12,000 Investment holding Limited** May 16, 1997 * Indirectly held through CNOOC International Limited. ** Formerly known as OOGC Myanmar Limited F-8 2. BASIS OF PRESENTATION Prior to the Reorganization, we and our subsidiaries did not exist as separate legal entities and our business operations were conducted by CNOOC and its various affiliates. In connection with the Reorganization, CNOOC's oil and gas exploration, development, production and sales businesses and operations conducted both inside and outside of the PRC were transferred to us. As CNOOC controlled the businesses and operations transferred to us before the Reorganization and continues to control us after the Reorganization, accordingly, the transfer of the businesses and operations has been accounted for as reorganization of companies under common control in a manner similar to a pooling of interests. On the basis described above, the financial statements have been prepared to present our operating results for the year ended December 31, 1999 as if the businesses and operations had been transferred to us at the beginning of the year presented. Consequently, the assets, liabilities, revenues and expenses that are clearly applicable to the businesses and operations transferred to us are included in the financial statements. For those expenses for which specific identification method was not practical, the following allocation basis was adopted: Basis ------------------- Salaries Number of employees Accounting and legal services Number of employees Advertising expenses Revenues Training Number of employees Pension liabilities Number of employees Rental and depreciation Floor area Other selling and administrative expenses Number of employees The employee count, floor area and revenue data used to allocate expenses represent historical operating statistics that existed during the years that they were being used to allocate costs. Management believes that the foregoing is a reasonable basis of estimating what our expenses would have been on a stand-alone basis prior to the Reorganization. The financial statements have been prepared in accordance with accounting principles generally accepted in Hong Kong ("Hong Kong GAAP"). This basis of accounting differs from that used in the management accounts of CNOOC to account for the businesses and operations transferred to us. The management accounts of CNOOC were prepared in accordance with the accounting principles and the financial regulations applicable to state-owned enterprises established in the PRC. As the accompanying consolidated financial statements are in conformity with Hong Kong GAAP, the significant differences between Hong Kong GAAP and generally accepted accounting principles in the United States of America ("US GAAP") are set forth in Note 36. F-9 3. PRINCIPAL ACCOUNTING POLICIES (a) Adoption of Statements of Standard Accounting Practice In the current year, we have adopted, for the first time, the following Statements of Standard Accounting Practice issued by the Hong Kong Society of Accountants ("Hong Kong SSAPs"): Hong Kong SSAP9 (revised) Event after the balance sheet date Hong Kong SSAP14 (revised) Leases Hong Kong SSAP26 Segment reporting Hong Kong SSAP28 Provisions, contingent liabilities and contingent assets Hong Kong SSAP29 Intangible assets Hong Kong SSAP30 Business combinations Hong Kong SSAP31 Impairment of assets Hong Kong SSAP32 Consolidated financial statements and accounting for investments in subsidiaries In addition to the adoption of the above standards, we have adopted the consequential changes made to Hong Kong SSAP 10 "Accounting for investments in associates", Hong Kong SSAP 17 "Property, plant and equipment", Hong Kong SSAP 18 "Revenue" and Hong Kong SSAP 21 "Accounting for interests in joint ventures". The impact of adopting the above new Hong Kong SSAPs is not significant and, accordingly, no prior period adjustment has been made on our financial statements. (b) Use of estimates The preparation of financial statements in conformity with generally accepted accounting principles requires us to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results may differ from those estimates. (c) Basis of consolidation The consolidated financial statements include the financial statements of us and our subsidiaries. This control is normally evidenced when we have the power to govern the financial and operating policies of an enterprise so as to benefit from its activities. In addition, if we hold, either directly or indirectly, more than 50% of the issued share capital or controls more than half of the voting power or the composition of the board of directors of the subsidiaries, control is assumed. Intragroup balances and transactions, and resulting unrealized profits are eliminated in full. Unrealized losses resulting from intragroup transactions are eliminated unless cost cannot be recovered. Consolidated financial statements are prepared using uniform accounting policies for like transactions and other events in similar circumstances. F-10 4. PRINCIPAL ACCOUNTING POLICIES (CONT'D) (d) Revenue recognition Provided it is probable that the economic benefits associated with a transaction will flow to us and the revenue and costs, if applicable, can be measured reliably, revenue is recognized on the following basis: (i) Oil and gas sales Revenues represent the invoiced value of sales of oil and gas attributable to our interests, net of royalties and government share of allocable share oil, and are recognized when the significant risks and rewards of ownership of oil and gas have been transferred to customers. Oil and gas lifted and sold by us above or below our participating interests in the production sharing contracts result in overlifts and underlifts. We record these transactions in accordance with the entitlement method under which overlifts are recorded as liabilities and underlifts are recorded as assets. Settlement will be in kind when the liftings are equalized or in cash when production ceases. We entered into a gas sales contract with a customer which contain take-or-pay clauses. The clause requires the customer to take a specified minimum volume of gas each year. If the minimum volume of gas is not taken, the customer must pay for the deficiency gas, even though the gas is not taken. The customer can offset the deficiency payment against any future purchases in excess of the specified volume. We recorded the deficiency payment as deferred revenue which is included in other payables until make-up gas is taken by the customer. As of December 31, 2001, deferred revenue amounted to approximately RMB5,581,000 (2000: RMB24,208,000). (ii) Marketing revenues Marketing revenues represent sales of oil purchased from the foreign partners under the production sharing contracts and revenues from trading of oil through our subsidiary in Singapore. The title, together with the risks and rewards of the ownership of such oil, are transferred to us from the foreign partners and other unrelated oil and gas companies before we sell such oil to our customers. The cost of the oil sold is included in crude oil and product purchases. (iii) Other income Other income mainly represents project management fees charged to the foreign partners and handling fees charged to customers and is recognized when the services are rendered. (iv) Interest income Interest income from deposits placed with banks and other financial institutions is recognized on a time proportion basis that takes into account the effective yield on the assets. (v) Dividend income Dividend income is recognized when the right to receive payment is established. (e) Research and development costs Research and development costs are recognized as expenses in the period in which they are incurred. F-11 3. PRINCIPAL ACCOUNTING POLICIES (CONT'D) (f) Property, plant and equipment Property, plant and equipment comprise oil and gas properties, land and buildings, and vehicles and office equipment. (i) Oil and gas properties For oil and gas properties, the successful efforts method of accounting is adopted. We capitalize initial acquisition costs of oil and gas properties, the costs of drilling and equipping successful exploratory wells, all development costs, including those renewals and betterments which extend the economic life of the assets, and the interest charges arising from borrowings used to finance the development of oil and gas properties before they are substantially ready for production. Costs of unsuccessful exploratory wells and all other exploration costs are expensed as incurred. In the absence of a determination as to whether the reserves that have been found can be classified as proved, the costs of drilling such an exploratory well will not be carried as an asset for more than one year following completion of drilling. If, when that year has passed, a determination that proved reserves have been found cannot be made, the well shall be assumed to be impaired, and its costs shall be charged to the consolidated statements of income. Productive oil and gas properties and other tangible and intangible costs of producing properties are amortized using the unit-of-production method on a property-by-property basis under which the ratio of produced oil and gas to the estimated remaining proved reserves is used to determine the depreciation, depletion and amortization provision. Costs associated with significant development projects are not depleted until commercial production commences and the reserves related to those costs are excluded from the calculation of depletion. We estimate future dismantlement and site restoration costs for oil and gas properties with reference to the estimates provided from either external or internal engineers after taking into consideration the anticipated method of dismantlement and the extent of site restoration required in accordance with current legislation and industry practices. We provide for the future dismantlement and site restoration allowance using the unit-of-production method. (ii) Land and buildings Land and buildings are stated at valuation less accumulated depreciation and accumulated impairment losses. Professional valuations are performed periodically with the last valuation performed on December 31, 2000. In the intervening years, our directors review the carrying value of land and buildings and adjustment is made where in our directors' opinion there has been a material change in value. Any increase in land and buildings valuation is credited to the revaluation reserves; any decrease is first offset against an increase in earlier valuation in respect of the same property and is thereafter charged to statements of income. Depreciation is calculated on the straight-line basis at annual rates estimated to write off valuation of each asset over its expected useful life, ranging from 30 to 50 years. (iii) Vehicles and office equipment Vehicles and office equipment are stated at cost less accumulated depreciation and accumulated impairment losses. The straight-line method is adopted to depreciate the cost less salvage value of these assets over their expected useful life. We estimate the useful lives of vehicles and office equipment to be 5 years. The useful lives of assets and method of depreciation, depletion and amortization are reviewed periodically. F-12 3. PRINCIPAL ACCOUNTING POLICIES (CONT'D) (f) Property, plant and equipment (cont'd) When assets are sold or retired, their costs or revalued amounts and accumulated depreciation, depletion and amortization are eliminated from the accounts and any gain or loss resulting from their disposal is included in the statements of income. (g) Subsidiaries A subsidiary is an enterprise in which we directly or indirectly hold more than 50% of its equity interest as a long-term investment and/or has the power to cast the majority of votes at its meetings of the board of directors. (h) Investment in an associated company Investment in associate where significant influence is exercised by us are accounted for using the equity method in the consolidated financial statements, whereby the investment is initially recorded at cost and adjusted thereafter to recognize our share of the post-acquisition profits or losses of the associate, distributions received from the associate and other necessary alterations in our proportionate interest in the associate arising from changes in the equity of the associate that have not been included in the statement of income and less any accumulated impairment losses. Our share of post-acquisition results of the associate is included in the consolidated statement of income. (i) Short-term investments Short-term investments are carried at fair value in the balance sheet. Any unrealized holding gain or loss of the investments is recognized in the statement of income in the period when it arises. Upon disposal or transfer of the investments, any profit or loss thereon is accounted for in the statement of income. (j) Inventories and supplies Inventories consist primarily of oil while supplies consist mainly of items for repair and maintenance of oil and gas properties. Inventories are valued at the lower of cost and net realizable value. Costs of inventories and supplies represent purchase or production cost of goods and are determined on a weighted average basis. Net realizable value is determined by reference to the sales proceeds of items sold in the ordinary course of business after the balance sheet date or to management's estimates based on prevailing market conditions. Supplies are capitalized to property, plant and equipment when used for renewals and betterments of oil and gas properties or recognized as expenses when used for daily operations. (k) Trade and other receivables Trade and other receivables are stated at their cost, after provision for doubtful accounts. (l) Cash and cash equivalents Cash represents cash on hand and deposits with banks and other financial institutions which are repayable on demand. Cash equivalents represent short-term, highly liquid investments which are readily convertible into known amounts of cash with original maturities of three months or less and that are subject to an insignificant risk of change in value. F-13 3. PRINCIPAL ACCOUNTING POLICIES (CONT'D) (m) Operating leases Lease of assets under which substantially all the risks and rewards of ownership are retained by the lessor are classified as operating leases. Lease payments under an operating lease are recognized as an expense on a straight-line basis over the lease term. (n) Provisions A provision is recognized when an enterprise has a present obligation (legal or constructive) as a result of a past event and it is probable (i.e. more likely than not) that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation. Provisions are reviewed at each balance sheet date and adjusted to reflect the current best estimate. Where the effect of the time value of money is material, the amount of a provision is the present value of the expenditures expected to be required to settle the obligation. (o) Taxation We provide for income taxes on the basis of our net income for financial reporting purposes, adjusted for income and expense items that are not assessable or deductible for income tax purposes. Deferred taxation is provided under the liability method in respect of timing differences between income as computed for taxation purposes and income as stated in the financial statements to the extent that it is probable that a liability or asset will crystallize. (p) Foreign currency The books and records are maintained in Renminbi ("RMB") except for our subsidiaries incorporated overseas. The books and records of the overseas subsidiaries are maintained either in Singapore dollars or United States dollars. Transactions in currencies other than the book currency during the year are translated into book currency at the exchange rates prevailing at the time of the transactions. Monetary assets and liabilities denominated in other currencies at the balance sheet date are translated into book currency at rates of exchange in effect at the balance sheet date. Exchange differences are dealt with in the consolidated statements of income in the period in which they arise. On consolidation, the financial statements of our overseas subsidiaries are translated into RMB using the closing rate method, whereby assets and liabilities are translated at the rates of exchange prevailing at the balance sheet date and income and expenses are translated at the average rates of exchange during the year. Share capital, share premium and retained earnings are translated at historical rates. Translation differences arising therefrom are dealt with as movements in reserves. For the convenience of the readers, translation of amounts from RMB into United States dollars ("US$") has been made at the rate of US$1.00=8.2766 on December 31, 2001. No representation is made that RMB amounts could have been, or could be, converted into US$ at that rate on December 31, 2001, or at any other rate. F-14 3. PRINCIPAL ACCOUNTING POLICIES (CONT'D) (q) Borrowing costs Borrowing costs include interest charges and other costs incurred in connection with the borrowing of funds, including amortization of discounts or premiums relating to borrowings, and amortization of ancillary costs incurred in connection with arranging borrowings to the extent that they are regarded as an adjustment to interest costs. Borrowing costs are expensed as incurred, except when they are directly attributable to the acquisition or construction of the property, plant and equipment that necessarily takes a substantial period of time to prepare for its intended use in which case they are capitalized as part of the costs of that asset. Capitalization of borrowing costs commences when expenditures for the asset and borrowing costs are being incurred and the activities to prepare the asset for its intended use are in progress. To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset is determined as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings. To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation is determined by applying a capitalsation rate to the expenditures on that asset. The capitalisation rate is the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalized incurred during a period should not exceed the amount of borrowing cost incurred during that period. (r) Retirement benefits and employee subsidies We provide defined contribution plans based on local laws and regulations. The plans cover full-time employees and provide for contributions ranging from 9% to 22.5% of salary. Our contributions to defined contribution plans are charged to expense in the year to which they relate. The cost of employee subsidies is charged to the statements of income as incurred. (s) Impairment of assets Property, plant and equipment and investment in an associated company and subsidiaries are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Whenever the carrying amount of an asset exceeds its recoverable amount, an impairment loss is recognized as an expense for items of property, plant and equipment and investments in an associated company and subsidiaries carried at cost, and treated as a revaluation decrease for buildings that are carried at revalued amounts to the extent that the impairment loss does not exceed the amount held in the revaluation surplus for that same building. The recoverable amount is the higher of an asset's net selling price and value in use. The net selling price is the amount obtainable from the sale of the asset in an arm's length transaction while value in use is the present value of estimated future cash flows expected to arise from the continuing use of the asset and from its disposal at the end of its useful life. Recoverable amounts are estimated for individual assets or, if it is not possible, for the cash-generating unit. Reversal of impairment losses recognized in prior years is recorded when the impairment losses recognized for the asset no longer exist or have decreased. The reversal is recorded in income or as a revaluation increase. F-15 3. PRINCIPAL ACCOUNTING POLICIES (CONT'D) (t) Repairs and maintenance Repairs and maintenance and overhaul costs are normally charged to the statement of income as operating expenses in the period in which it is incurred. (u) Financial instruments We have currency swap contracts with financial institutions which are not designated as hedging instruments and are carried at fair value, with changes in fair value included in the statement of income. (v) Segments Business segments: for management purposes we are organized on a worldwide basis into three major operating segments. The divisions are the basis upon which we report our primary segment information. Financial information on business and geographical segments is presented in Note 32. Intersegment transactions: segment revenue, segment expenses and segment performance include transfers between business segments and between geographical segments. Such transfers are accounted for at cost. Those transfers are eliminated in consolidation. (w) Contingencies Contingent liabilities are not recognized in the financial statements. They are disclosed unless the possibility of an outflow of resources embodying economic benefits is remote. A contingent asset is not recognized in the financial statements but disclosed when an inflow of economic benefits is probable. (x) Subsequent events Post-year-end events that provide additional information about a company's position at the balance sheet date or those that indicate the going concern assumption is not appropriate (adjusting events) are reflected in the financial statements. Post-year-end events that are not adjusting events are disclosed in the notes when material. F-16 4. PRODUCTION SHARING CONTRACTS We perform a significant amount of our oil and gas activities through production sharing contracts with international oil companies ("foreign partners"). For most production sharing contracts, foreign partners are required to bear all exploration costs during the exploration period and such exploration costs can be recovered according to the production sharing formula after commercial discoveries are made and production begins. The development and operating costs are funded by us and the foreign partners according to the respective participating interests. We have the option to take a participating interest of up to 51% in a production sharing contract and may exercise such option after the foreign partners have independently undertaken all the exploration risks and costs and made viable commercial discoveries. The foreign partners retain the remaining participating interests. After we exercise the option to take a participating interest in a production sharing contract, we account for the oil and gas properties using the "proportional method" under which we recognize our share of development costs, revenues and expenses from such operations based on our participating interest in the production sharing contract. We do not account for the exploration costs incurred by our foreign partners and their share of development costs and revenues and expenses from such operations. Part of the annual gross production of oil and gas is distributed to the PRC government for the payment of royalties pursuant to a sliding scale. We and the foreign partners also pay a production tax to the tax bureau at a pre-determined rate (see Note 10). In addition, there is a pre-agreed portion of oil and gas designated to recover all exploration costs, development costs, operating costs incurred and related interests according to the participating interests between us and the foreign partners. Any remaining oil after the foregoing is first distributed to the PRC government as share oil on a pre-determined ratio pursuant to a sliding scale and then distributed to us and the foreign partners based on their respective participating interests. As government share is not included in our interest in the annual production, our net sales do not include the sales revenue of the government share oil. The foreign partners have the right to take possession of their allocable remainder oil for sale in the international market or to negotiate with us to sell their allocable remainder oil to us for resale in the PRC market. F-17 5. OIL AND GAS SALES 1999 2000 2001 ----------------- ----------------- ------------------ RMB'000 RMB'000 RMB'000 Gross sales 12,681,879 21,747,888 19,663,251 Royalties (106,899) (208,885) (283,014) Government share oil (1,177,107) (2,719,680) (1,819,449) ----------------- ----------------- ------------------ 11,397,873 18,819,323 17,560,788 ================== ================= ================== 6. MARKETING PROFIT 1999 2000 2001 ------------------ ---------------- ------------------ RMB'000 RMB'000 RMB'000 Marketing revenues 3,804,367 5,126,015 2,537,032 Crude oil and product purchases (3,736,671) (5,097,765) (2,453,312) ----------------- ---------------- ------------------ 67,696 28,250 83,720 ================= ================= ================== 7. DIRECTORS' AND FIVE HIGHEST PAID INDIVIDUALS (a) Details of directors' emoluments were as follows: 1999 2000 2001 ------------------- ------------------ ------------------- RMB'000 RMB'000 RMB'000 Fees for executive directors 194 - - Fees for non-executive directors - - 890 Other emoluments for executive directors - basic salaries and allowances 1,847 400 6,106 - bonus 96 440 560 - pension scheme contribution 129 160 207 - other 1,136 1,500 1,500 The emoluments of the directors analyzed by the number of directors and emolument ranges were as follows: Number of Directors --- 1999 2000 2001 ----------------- ---------------- ------------------ Up to HK$1,000,000 7 7 6 HK$1,000,001 - HK$1,500,000 - - - HK$1,500,001 - HK$2,000,000 - - 2 HK$2,000,001 - HK$2,500,000 - - - HK$2,500,001 - HK$3,000,000 - - 1 ----------------- ---------------- ------------------ 7 7 9 ================== ================= ================== No directors had waived or agreed to waive any emoluments during the years ended December 31, 2001, 2000, and 1999. F-18 7. DIRECTORS' AND FIVE HIGHEST PAID INDIVIDUALS (CONT'D) (b) Details of emoluments of the five highest paid individuals were as follows: 1999 2000 2001 ------------------ ----------------- ------------------ RMB'000 RMB'000 RMB'000 Basic salaries and allowances 1,847 400 7,280 Bonus 96 440 1,280 Pension scheme contribution 129 160 416 Other 1,136 1,500 1,500 Number of directors 5 5 4 Number of employees - - 1 Their emoluments were within the following bands: Number of Senior Executives --- 1999 2000 2001 ------------------ ---------------- ------------------ Up to HK$1,000,000 5 5 1 HK$1,000,001 - HK$1,500,000 - - - HK$1,500,001 - HK$2,000,000 - - 2 HK$2,000,001 - HK$2,500,000 - - - HK$2,500,001 - HK$3,000,000 - - 2 ------------------ ---------------- ------------------ 5 5 5 ================== ================= ================== During the years ended December 31, 2001, 2000 and 1999, no emoluments were paid to the five highest paid individuals (including directors, members and employees) as an inducement to join or upon joining us or as compensation for loss of office. 8. SELLING AND ADMINISTRATIVE EXPENSES 1999 2000 2001 ------------------ ---------------- ------------------ RMB'000 RMB'000 RMB'000 Salary and staff benefits 136,779 172,593 228,782 Utility and office expenses 61,674 70,069 89,462 Recovery of doubtful accounts (5,382) (57,658) (4,966) Transportation and entertainment 40,879 60,682 64,923 Rentals and maintenance 78,583 89,184 121,483 Selling expenses 16,502 36,481 38,069 Other 187,450 84,651 77,636 ----------------- ---------------- ------------------ 516,485 456,002 615,389 ================== ================= ================== F-19 9. INTEREST, NET 1999 2000 2001 ---------------- ----------------- ----------------- RMB'000 RMB'000 RMB'000 Interest expense on bank loans which are: - wholly repayable within five years 355,876 241,749 219,045 - not wholly repayable within five years 337,629 191,755 81,634 Interest expense to CNOOC 6,225 41,500 8,415 Other borrowing costs - - 6,510 Less: Amounts capitalized in property, plant and equipment (78,026) - (198,970) ---------------- ----------------- ----------------- 621,704 475,004 116,634 Interest income (53,709) (236,624) (317,706) ---------------- ----------------- ----------------- 567,995 238,380 (201,072) ================= ================== ================== The capitalized interest rate represented the cost of capital from raising the related borrowings and varied from 2.35% to 9.15% per annum for the year ended December 31, 2001 (2000: -, 1999: 6% to 7%). 10. TAXATION (a) Income tax We and our subsidiaries are subject to income taxes on an entity basis on income arising in or derived from the tax jurisdictions in which we are domiciled and operate. We are not liable for profits tax in Hong Kong as we do not have any assessable income currently sourced from Hong Kong. Our subsidiary, CNOOC China Limited, is a wholly foreign owned enterprise established in the PRC. It is exempt from 3% local surcharges and is subject to an enterprise income tax of 30% under the prevailing tax rules and regulations. Moreover, CNOOC China Limited was entitled to a 50% reduction of enterprise income tax for three years until end of year 2000. Starting form January 1, 2001, CNOOC China Limited is subject to enterprise income tax at the normal rate of 30%. Further, CNOOC performed assets revaluation in 1995 on its then oil properties and other plant and equipment which were transferred to CNOOC China Limited in 1999 upon the Reorganization of CNOOC. According to a notice from the tax bureau, the related revaluation surplus was deductible for tax reporting purpose by CNOOC. Based on a confirmation received from the local tax bureau in 2001, the related depreciation and amortization can still be deductible for tax purpose by CNOOC China Limited. However, such treatment may be subject to review by higher tax authorities. Should the depreciation and amortization not be tax deductible, an additional enterprise income tax liability of approximately RMB75,000,000 for the year ended December 31, 2001 may arise. We believe that the possibility of such a liability arising is unlikely. Our subsidiary in Singapore, China Offshore Oil (Singapore) International Pte. Ltd., is subject to income tax at the rate of 10% and 26% respectively for its oil trading activities and other income producing activities. Our subsidiaries owning interests in oil properties in Indonesia are subject to corporate and dividend tax of 56% before August 2000. Starting from August 2000 with the renewal of production sharing contracts, the tax rate was reduced to 44%. All of our other subsidiaries are not subject to income taxes in their respective jurisdictions for the years presented. F-20 10. TAXATION (CONT'D) (a) Income tax (Cont'd) An analysis of the provision for taxation in the consolidated statements of income was as follows: 1999 2000 2001 ----------------- ----------------- ----------------- RMB'000 RMB'000 RMB'000 Overseas income taxes - Current 22,246 43,873 20,401 - Deferred 43 - - PRC enterprise income tax - Current 462,401 1,600,608 2,715,409 - Deferred 237,235 281,595 312,417 ----------------- ----------------- ----------------- 721,925 1,926,076 3,048,227 ================= ================= ================= With the tax holiday exemption, current income tax liabilities of our subsidiary in the PRC were reduced by approximately RMB1,920,730,000 and RMB536,385,000 respectively during the years ended December 31, 2000 and 1999. The tax holiday exemption also increased the net income per share by RMB0.30 and RMB0.09 for the years ended December 31, 2000 and 1999. The reconciliation of the statutory PRC enterprise income tax rate to our effective income tax rate was as follows: 1999 2000 2001 ----------------- ----------------- ----------------- RMB'000 RMB'000 RMB'000 Statutory PRC enterprise income tax rate 33.0% 33.0% 33.0% Effect of tax holiday (15.0%) (15.0%) - Effect of tax exemption granted (2.1%) (3.0%) (3.0%) Effect of future tax rate changes on originating timing differences 2.7% 1.2% - Effect of different tax rates for overseas subsidiaries 0.2% 0.3% (1.2%) Tax effect of additional depreciation on revaluation and other permanent differences (3.9%) (0.7%) (1.1%) ----------------- ----------------- ----------------- Effective income tax rate 14.9% 15.8% 27.7% ================= ================= ================= F-21 10. TAXATION (CONT'D) (a) Income tax (Cont'd) The tax effect of significant timing differences of us was as follows: 2000 2001 ----------- ---------- RMB'000 RMB'000 Deferred tax assets - Dismantlement and site restoration allowance 452,329 479,439 - Provision for impairment of property, plant and equipment and write-off of unsuccessful exploratory drillings 1,266,523 1,880,791 ----------- ---------- 1,718,852 2,360,230 Deferred tax liabilities - Accelerated amortization allowance for oil and gas properties (3,170,072) (4,123,867) ----------- ---------- Net deferred tax liabilities (1,451,220) (1,763,637) =========== ========== There were no significant unprovided deferred income taxes during the years presented. (b) Other taxes Our PRC subsidiary pays the following taxes: - production taxes equal to 5% of independent production and production under production sharing contracts; - business tax of 3% to 5% on other income. 11. DIVIDENDS The payment of future dividends will be determined by our board of directors. The payment of dividends will depend upon, among other things, future earnings, capital requirements and financial condition and general business conditions of us. Our ability to pay dividends will also depend on the cash flows determined by the dividends, if any, received by us from our subsidiaries and associated company. As the controlling shareholder, CNOOC will be able to influence our dividend policy. Cash dividends to the shareholders in Hong Kong will be paid in Hong Kong dollars and dividends to the ADS holders will be paid to the depositary in Hong Kong dollars and will be converted by the depositary into United States dollars and paid to the holders of ADSs. On August 27, 2001, the board of directors declared a 2001 interim dividend of HK$0.10 per share, totaling approximately RMB871,194,000 to its shareholders, which was paid in October 2001. On December 20, 2000, our board of directors proposed a dividend of RMB0.98 per share, totaling approximately RMB6,426,424,000, to our shareholders for the year ended December 31, 2000. The dividend distribution was approved by the shareholders in their annual general meeting held on February 4, 2001. F-22 11. DIVIDENDS (CONT'D) Immediately before the Reorganization effectively on October 1, 1999, the retained earnings of CNOOC China Limited as of September 30, 1999 amounting to RMB739,665,000 as reported in accordance with Accounting Regulation for Enterprises with Foreign Investment of the PRC ("PRC GAAP") were distributed to CNOOC. In accordance with a board resolution dated March 10, 2000, we declared a dividend amounting to RMB1,045,365,000 to CNOOC for the period from our incorporation to December 31, 1999. The dividend was paid to CNOOC in March 2000 in cash immediately after the declaration. 12. NET INCOME PER SHARE AND PER ADS The calculation of basic earnings per share for the years ended December 31, 2001 and 2000 is based on the net income attributable to ordinary shareholders, divided by the weighted average number of ordinary shares outstanding during the years of 7,941,383,305 shares and 6,331,114,421 shares respectively. The calculation of basic earnings per share for the year ended December 31, 1999 is based on the net income divided by the number of shares outstanding immediately after the Reorganization of 6,000,000,000 shares. Diluted earnings per share for the year ended December 31, 2001 is computed by dividing net income for the year attributable to ordinary shareholders of RMB7,957,631,000 by the weighted average number of ordinary shares outstanding during the year adjusted for the effects of all dilutive potential ordinary shares under the share option scheme (see Note 24). The weighted average number of ordinary shares used to compute diluted earnings per share was 7,942,288,803 shares for the year ended December 31, 2001. There were no potential dilutive ordinary shares outstanding for the years ended December 31, 2000 and 1999. Reconciliation of the number of ordinary shares for calculation of basic and diluted earnings per share for the year ended December 31, 2001: 2001 ----------------- Weighted average number of ordinary shares used in calculating basic earnings per share 7,941,383,305 Effect of all dilutive potential ordinary shares under the share option scheme 905,498 ------------------ Weighted average number of ordinary shares used in calculating diluted earnings per share 7,942,288,803 =================== Net income per ADS for the three years ended December 31, 2001 has been computed by dividing net income by the number of ADS outstanding. Each ADS represented 20 shares. F-23 13. PROPERTY, PLANT AND EQUIPMENT, NET Movements in our property, plant and equipment were: 2001 -- Oil and gas Land and Vehicles and Total properties buildings office equipment ------------------ ----------------- ----------------- ---------------- RMB'000 RMB'000 RMB'000 RMB'000 Cost: Beginning balance 37,319,924 824,781 39,837 38,184,542 Additions 4,320,675 - 18,063 4,338,738 Disposals and written off (463,140) - - (463,140) ------------------ ------------------ ----------------- ----------------- Ending balance 41,177,459 824,781 57,900 42,060,140 ------------------ ------------------ ------------------ ----------------- Representing: At cost 41,177,459 - 57,900 41,235,359 At revaluation - 824,781 - 824,781 ------------------ ------------------ ----------------- ----------------- 41,177,459 824,781 57,900 42,060,140 ------------------ ------------------ ----------------- ----------------- Accumulated depreciation, depletion and amortization: Beginning balance (15,482,082) (30,280) (17,805) (15,530,167) Charge for the year (2,572,896) (25,373) (4,530) (2,602,799) Impairment (99,675) - - (99,675) ------------------ ----------------- ------------------ ----------------- Ending balance (18,154,653) (55,653) (22,335) (18,232,641) ------------------ ----------------- ------------------ ----------------- Net book value: Beginning of year 21,837,842 794,501 22,032 22,654,375 =================== ================== =================== ================= End of year 23,022,806 769,128 35,565 23,827,499 =================== ================== =================== ================= Had the property, plant and equipment been carried at cost less accumulated depreciation, depletion and amortization, the carrying amount of each class would have been: Cost 41,177,459 550,110 57,900 41,785,469 Accumulated depreciation, depletion and amortization (18,154,653) (38,914) (22,335) (18,215,902) ------------------- ------------------ ----------------- ----------------- 23,022,806 511,196 35,565 23,569,567 =================== ================== ================== ================= F-24 13. PROPERTY, PLANT AND EQUIPMENT, NET (CONT'D) 2000 -- Oil and gas Land and Vehicles and Total properties buildings office equipment ------------------ ----------------- ----------------- ----------------- RMB'000 RMB'000 RMB'000 RMB'000 Cost: Beginning balance 33,756,460 374,862 35,185 34,166,507 Additions 4,233,845 345,846 4,652 4,584,343 Revaluation - 104,073 - 104,073 Disposals (670,381) - - (670,381) ------------------ ----------------- ----------------- ----------------- Ending balance 37,319,924 824,781 39,837 38,184,542 ------------------ ----------------- ----------------- ----------------- Representing: At cost 37,319,924 - 39,837 37,359,761 At revaluation - 824,781 - 824,781 ------------------ ----------------- ----------------- ----------------- 37,319,924 824,781 39,837 38,184,542 ------------------ ----------------- ----------------- ----------------- Accumulated depreciation, depletion and amortization: Beginning balance (13,216,562) (20,598) (21,822) (13,258,982) Charges for the year (2,629,323) (9,682) 4,017 (2,634,988) Write back on disposals 363,803 - - 363,803 ------------------ ----------------- ----------------- ----------------- Ending balance (15,482,082) (30,280) (17,805) (15,530,167) ------------------ ----------------- ----------------- ----------------- Net book value: Beginning of year 20,539,898 354,264 13,363 20,907,525 =================== ================== ================== ================ End of year 21,837,842 794,501 22,032 22,654,375 ===================

================== ================== ================= Had the property, plant and equipment been carried at cost less accumulated depreciation, the carrying amount of each class would have been: Cost 37,319,924 550,110 39,837 37,909,871 Accumulated depreciation (15,482,082) (22,697) (17,805) (15,522,584) ------------------ ----------------- ----------------- ----------------- 21,837,842 527,413 22,032 22,387,287 =================== ================== ================== ================= Impairment loss for the year ended December 31, 2001, represented the estimated impairment resulting from downward revision of the reserves of certain oil fields. Our land and buildings are held outside Hong Kong with lease terms of 50 years. Certain land use rights which were previously granted by the PRC government at no cost. The land and buildings were revalued by Sallmanns (Far East) Limited, Chartered Surveyors (the "Valuer") as of December 31, 2000 and August 31, 1999 using a depreciated replacement cost approach. The depreciated replacement cost approach considers the cost to reproduce or replace in new condition the property being appraised in accordance with current construction costs for similar property in the locality with allowance for accrued depreciation as evidenced by observed condition or obsolescence present, whether arising from physical, functional or economic causes. The Valuer assumed that the assets would be used for the purposes for which they are presently used and did not consider alternative uses. The revaluation surplus of approximately RMB104,073,000 in 2000 (1999: RMB170, 598,000) arising from the revaluation of the land and buildings has been recorded by us. F-25 14. INVESTMENT IN AN ASSOCIATED COMPANY Investment in an associated company represents a 30% equity interest of CNOOC China Limited in Shanghai Petroleum and Natural Gas Company Limited ("SPC"). SPC was incorporated on September 7, 1992 in the PRC with limited liability and is principally engaged in offshore petroleum exploration, development, production and sales in the South Yellow Sea and East China Sea areas. The issued and paid up capital of SPC is RMB900,000,000. 2000 2001 -------------------- -------------------- RMB'000 RMB'000 Investment at cost - unlisted 270,000 270,000 Accumulated share of profits 222,027 290,990 Dividends received (21,000) (99,000) -------------------- -------------------- 471,027 461,990 ===================== ===================== The directors are of the opinion that the underlying value of the investment in the associated company was not less than the carrying amount of the associated company as of December 31, 2001 and 2000. 15. ACCOUNTS RECEIVABLE, NET 2000 2001 -------------------- -------------------- RMB'000 RMB'000 Trade receivables 1,931,883 1,204,907 Less: Allowance for doubtful accounts (15,693) (10,727) -------------------- -------------------- 1,916,190 1,194,180 ===================== ===================== The customers are required to make payment within 30 days after the delivery of oil and gas. As of December 31, 2001 and 2000, substantially all the accounts receivable were aged within six months. 16. INVENTORIES AND SUPPLIES 2000 2001 -------------------- -------------------- RMB'000 RMB'000 Materials and supplies 448,536 428,991 Oil in tanks 178,328 198,346 -------------------- -------------------- 626,864 627,337 ===================== ===================== F-26 17. SHORT-TERM INVESTMENTS As of December 31, 2001 and 2000, short-term investments mainly represented investments in liquidity funds and were stated at fair value at the balance sheet dates. Details were as follows: 2000 2001 ------------------- ------------------- RMB'000 RMB'000 Liquidity funds - 7,675,622 Corporate bonds - 1,177,991 Common stock 300,000 42,191 ------------------- ------------------- 300,000 8,895,804 ==================== ==================== Investment income for the years is summarized as follows: 1999 2000 2001 -------------------- ------------------ ------------------- RMB'000 RMB'000 RMB'000 Interest - - 21,344 Dividends - - 123,213 Realized gains on investments - - 32,297 Unrealized gains on investments - - 43,796 -------------------- ------------------ ------------------- - - 220,650 ===================== =================== ================== 18. LONG-TERM BANK LOANS As of December 31, 2001 and 2000, our long-term bank loans were used primarily to finance the development of oil and gas properties and to meet working capital requirements. Interest rate and final maturity 2000 2001 ------------------------------------- ------------------- ------------------ RMB'000 RMB'000 RMB denominated Floating prevailing market rate bank loans adjusted annually with maturities through 2006 675,000 670,000 Fixed interest rate at 5.94% per annum through 2005 75,270 66,270 US$ denominated Floating LIBOR rate with maturities bank loans through 2003 310,429 1,177,761 Floating prevailing rate for six months foreign currency loans quoted by domestic banks, with maturities through 2003 1,475,157 - Fixed interest rate of 9.15% per annum with maturities through 2006 827,810 827,660 Japanese Yen denominated Fixed interest rate ranging from 2.35% to bank loans 5.15% per annum, with maturities through 2007 2,382,711 1,745,848 -------------------- ---------------- 5,746,377 4,487,539 Less: current portion (997,533) (1,231,840) -------------------- ---------------- 4,748,844 3,255,699 =====================

================ F-27 18. LONG-TERM BANK LOANS (CONT'D) As of December 31, 2001 and 2000, LIBOR was approximately 2.0% and 6.2% respectively. As of December 31, 2001 and 2000, all our bank loans were unsecured and approximately RMB991,537,000 and RMB1,475,157,000 of the outstanding borrowings were guaranteed by CNOOC. The maturities of long-term bank loans are as follows: 2000 2001 --------------- ----------- RMB'000 RMB'000 Balances due: - Within one year 997,533 1,231,840 - After one year but within two years 1,280,876 794,593 - After two years but within three years 837,064 462,564 - After three years but within four years 504,976 483,364 - After four years but within five years 525,776 1,231,423 - Beyond five years 1,600,152 283,755 ---------------- ----------- 5,746,377 4,487,539 Amount due within one year shown under current liabilities (997,533) (1,231,840) ---------------- ----------- 4,748,844 3,255,699 ================ =========== Supplemental information with respect to long-term bank loans: Maximum Average Weighted Weighted amount amount average average outstanding outstanding interest rate Balance at interest rate during the during the during the year end at year end year year* year** -------------- -------------- ------------- --------------- --------------- RMB'000 % RMB'000 RMB'000 % For the year ended December 31, 1999 8,288,824 6.07 10,030,187 9,159,506 6.29 2000 5,746,377 6.28 8,908,583 7,017,601 6.18 2001 4,487,539 5.03 5,746,377 5,116,958 5.66 ------------ * The average amount outstanding is computed by dividing the total of outstanding principal balances as of January 1 and December 31 by 2. ** The weighted average interest rate is computed by dividing the total of weighted average interest rates as of January 1 and December 31 by 2. F-28 19. ACCOUNTS PAYABLE As of December 31, 2001 and 2000, substantially all the accounts payable were aged within six months. 20. OTHER PAYABLES AND ACCRUED LIABILITIES 2000 2001 ---------------- ---------------- RMB'000 RMB'000 Accrued payroll and welfare payable 84,136 132,773 Accrued expenses 288,873 434,766 Advance from customers 30,640 86,301 Other payables 254,007 159,306 ----------------- ----------------- 657,656 813,146 ================= ================= 21. BALANCES WITH PARENT COMPANY AND RELATED COMPANIES Except for RMB1,660,000,000 payable to CNOOC as of December 31, 2000 which bore interest at 2.5% per annum, all other balances with CNOOC and related companies were unsecured, non-interest bearing and repayable on demand. 2000 2001 ----------------- ------------------ RMB'000 RMB'000 Due to parent company - Advances from CNOOC 122,497 125,493 - Debt payable to CNOOC for pension liabilities 1,660,000 - ----------------- ------------------ 1,782,497 125,493 ================= ================== 22. DISMANTLEMENT AND SITE RESTORATION ALLOWANCE Dismantlement and site restoration allowance represents the estimated costs of dismantling offshore oil platforms and abandoning oil and gas properties. Dismantlement and site restoration allowance has been classified under long-term liabilities. The details of the dismantlement and site restoration allowance were as follows: 2000 2001 ----------------- ------------------ RMB'000 RMB'000 Total anticipated cost 2,757,902 2,962,004 Total cost accrued 1,507,763 1,598,130 F-29 23. SHARE CAPITAL Number of shares Share capital --------------------- -------------------- Authorized: HK$'000 Ordinary shares of HK$0.10 each At December 31, 2001 and 2000 15,000,000,000 1,500,000 ===================== ===================== Number of shares Share capital Share capital ---------------- ---------------- ----------------- Issued and fully paid: HK$'000 Equivalent of RMB'000 Ordinary shares of HK$0.10 each At January 1, 2000 6,000,000,000 600,000 641,561 Issue of shares to corporate investors (i) 557,575,755 55,758 59,620 ---------------- ---------------- ---------------- At December 31, 2000 6,557,575,755 655,758 701,181 ================ ================ ================ Ordinary shares of HK$0.10 each At January 1, 2001 6,557,575,755 655,758 701,181 Issue of shares during the initial public offering (ii) 1,656,589,900 165,659 175,797 ---------------- ---------------- ---------------- At December 31, 2001 8,214,165,655 821,417 876,978 ================ ================ ================ (i) According to the subscription agreements dated March 17, 2000, May 31, 2000 and June 28, 2000, we issued in total 557,575,755 new shares to eight unaffiliated entities at US$0.825 per share ("Private Placements") for aggregate net proceeds of approximately RMB3,769,664,000, after deducting expenses of approximately RMB39,136,000. (ii) We completed our initial public offering in 2001 and the details were as follows: - issued 1,442,426,000 shares of HK$0.10 each at HK$6.01 per share and the shares and in the form of ADSs were listed on the Stock Exchange of Hong Kong Limited ("Hong Kong Stock Exchange") and the New York Stock Exchange on February 28, 2001 and February 27, 2001 respectively; and - issued 214,163,900 shares of HK$0.10 each at HK$6.01 per share on March 23, 2001 upon the exercise of an over-allotment option by the underwriters of the global offering. The net proceeds from the initial public offering (including the exercise of the over-allotment option) amounted to approximately RMB10,101,564,000, after deducting expenses of approximately RMB288,058,000. F-30 24. SHARE OPTION SCHEME We have a share option scheme which provides for the grant of options to our senior management. Under this share option scheme, the remuneration committee of our board of directors will from time to time propose for board approval the recipient of and number of shares underlying each option. The scheme provides for issuance of options exercisable for shares granted under this scheme and the pre-global offering share option scheme as described below not exceeding 10% of the total number of our outstanding shares, excluding shares issued upon exercise of options granted under the scheme from time to time. The exercise price of an option will be determined by our board of directors at its discretion upon the grant date, as long as the price will not be less than a specified minimum which is the higher of: o the nominal value of the shares; and o 80% of the average of the closing prices of shares on the Hong Kong Stock Exchange for the five trading days immediately preceding the date of grant of the option on which there were dealings in shares on the Hong Kong Stock Exchange. On August 27, 2001, our board of directors approved under the above stock option scheme to grant options of 8,820,000 shares, and the exercise price is HK$ 6.16 per share. Options granted under this scheme may be exercised, in whole or in part, in accordance with the following vesting schedule: o one-third of the shares subject to the option shall vest on the first anniversary of the date of the grant; o one-third of the shares subject to the option shall vest on the second anniversary of the date of the grant; and o one-third of the shares subject to the option shall vest on the third anniversary of the date of the grant. On February 4, 2001, we adopted a pre-global offering share option scheme. Under this scheme, options of an aggregate of 4,620,000 shares were granted to the senior management on March 12, 2001. The exercise price is HK$5.95 per share. Options granted under this scheme will be exercisable, in whole or in part, in accordance with the following vesting schedule: o 50% of the shares underlying the option shall vest 18 months after the date of the grant, and o 50% of the shares underlying the option shall vest 30 months after the date of the grant. Outstanding options under the two option plans described above will remain in force for a maximum of ten years from the grant date. No options have been exercised since the date of grant and up to the date when the board of directors approved the financial statements. 25. F-31 25. MOVEMENT IN EQUITY Movements in equity were as follows: Cumulative Paid-in Share Revaluation translation Statutory Retained capital premium reserves reserve reserve earnings Total ------------ ----------- ----------- ------------ --------- ----------- ------------ RMB'000 RMB'000 RMB'000 RMB'000 RMB'000 RMB'000 RMB'000 Balances at January 1, 1999 2,485,762 - - - - 3,872,932 6,358,694 Net income for the year - - - - - 4,111,439 4,111,439 Appropriation to statutory - - reserve (i) - - 100,874 (100,874) - Distribution to CNOOC (note 11) - - - - - (739,665) (739,665) Dividends (Note 11) - - - - - (1,045,365) (1,045,365) Return of capital to CNOOC - - (ii) (471,461) - - - (471,461) Share premium arising form the Reorganization (1,372,301) 7,124,955 - - - (5,752,654) - Surplus on revaluation of - 170,598 properties - - - - 170,598 ------------ ----------- ----------- ------------ --------- ----------- ------------ Balances at January 1, 2000 642,000 7,124,955 170,598 - 100,874 345,813 8,384,240 Net income for the year - - - - - 10,296,600 10,296,600 Appropriation to statutory - - reserve (i) - - 847,464 (847,464) - Dividends (Note 11) - - - - - (6,426,424) (6,426,424) Net proceeds from Private Placements (Note 23(i)) 59,181 3,710,483 - - - - 3,769,664 Surplus on revaluation of properties (Note 13) - - 104,073 - - - 104,073 Foreign currency translation difference - - - (6,350) - - (6,350) ------------ ----------- ----------- ------------ --------- ----------- ------------ Balances at January 1, 2001 701,181 10,835,438 274,671 (6,350) 948,338 3,368,525 16,121,803 Foreign currency translation difference - - 702 - - 702 Net income for the year - - - - 7,957,631 7,957,631 Appropriation to statutory reserve (i) - - - 587,022 (587,022) - Dividends (Note 11) - - - - (871,194) (871,194) Net proceeds from issue of ordinary shares (Note 23(ii)) 175,797 9,925,767 - - - - 10,101,564 ------------ ----------- ----------- ------------ --------- ----------- ------------ Balances at December 31, 2001 876,978 20,761,205 274,671 (5,648) 1,535,360 9,867,940 33,310,506 ============ =========== =========== ============ ========= =========== ============ As of December 31, 2001 and 2000, our distributable profits amounted to approximately RMB220,127,000 and RMB17,420,000 respectively. Included in retained earnings is an amount of RMB311,990,000 (2000: 222,027,000), being the retained earnings attributable to an associated company. The application of the share premium account is governed by Section 48B of the Hong Kong Companies Ordinance. The translation reserves and revaluation reserves have been established and will be dealt with in accordance with the accounting policies adopted for foreign currency translation and the revaluation of land and buildings. F-32 25. MOVEMENT IN EQUITY (CONT'D) (i) According to the laws and regulations of the PRC and articles of association of CNOOC China Limited, CNOOC China Limited is required to provide for certain statutory funds, namely, general reserve fund and staff and workers' bonus and welfare fund, which are appropriated from net income and after making good losses from previous years, but before dividend distribution. CNOOC China Limited is required to allocate at least 10% of its net income as reported in accordance with the generally accepted accounting principles in the PRC ("PRC GAAP") to the general reserve fund until the balance of such fund has reached 50% of its registered capital. Appropriation to staff and workers' bonus and welfare fund, which is determined at the discretion of the directors of CNOOC China Limited, is charged to expense as incurred under Hong Kong GAAP. The general reserve fund can only be used, upon approval by the relevant authority, to offset against accumulated losses or increase capital. Staff and workers' bonus and welfare fund can only be used for special bonuses or collective welfare of employees, and assets acquired through this fund shall not be taken as assets of CNOOC China Limited. As of December 31, 2001 and 2000, the general reserve fund appropriated amounted to RMB1,535,360,000 and RMB948,338,000, representing approximately 15.4% and 9.5% of the total registered capital of CNOOC China Limited. (ii) This represents net assets distributed to CNOOC for no monetary consideration. Such assets and liabilities were mainly in connection with ancillary, social and supporting operations which were retained by CNOOC under the Reorganization but were generated from earnings of the exploration, development, production and sales businesses transferred to us. 26. RETIREMENT BENEFITS All our full-time employees in the PRC are covered by a government regulated pension, and are entitled to an annual pension equal to their basic salaries at their retirement dates. The PRC government is responsible for the pension liabilities to these retired employees. We are required to make annual contributions to the government-regulated pension at rates ranging from 9% to 22.5% of the employees' basic salaries. The attribution to the PRC government pension plan for the year ended December 31, 2001 amounted to approximately RMB6,392,000 (2000: RMB12,842,000, 1999: RMB12,207,000). We are required to make contribution to mandatory provident fund at a rate of 5% of the basic salaries for all full-time employees in Hong Kong. The related pension costs are expensed as incurred. F-33 27. RELATED PARTY TRANSACTIONS Companies are considered to be related if one company has the ability, directly or indirectly, to control the other company or exercise significant influence over the other company in making financial and operating decisions. Companies are also considered to be related if they are subject to common control or common significant influence. We entered into several agreements with CNOOC and its affiliates, which govern the provision of materials, utilities and ancillary services, the provision of technical services, the provision of research and development services, the provision of bank guarantees and various other commercial arrangements. (a) Provision of materials, utilities and ancillary services CNOOC China Limited has entered into a materials, utilities and ancillary services supply agreements with the affiliates of CNOOC. Under these agreements, the affiliates of CNOOC provide to CNOOC China Limited various materials, utilities and ancillary service for the term of three years from September 9, 1999. The materials, utilities and ancillary services are provided at: o state-prescribed prices, o where there is no state-prescribed price, market prices, including the local or national market prices or the prices at which CNOOC's affiliates previously provided the relevant materials, utilities and ancillary services to independent third parties, or o where neither of the prices mentioned above is applicable, the cost to CNOOC's affiliates of providing the relevant materials, utilities and services, including the cost of sourcing or purchasing from third parties, plus a margin of not more than 5% before any applicable taxes. (b) Technical services CNOOC China Limited has entered into technical service agreements with specialized companies formed by CNOOC. According to these agreements, we used the technical services provided by these specialized companies, including: o offshore drilling; o ship tugging, oil tanker transportation and security services; o well survey, well logging, well cementation and other related technical services; o collection of geophysical data, ocean geological prospecting, and data processing; and o design, construction, installation and test of offshore and onshore production facilities. F-34 27. RELATED PARTY TRANSACTIONS (CONT'D) (c) Research and development services Under the terms of a general research and development services agreement with CNOOC's subsidiary, China Offshore Oil Research Centre (the "Centre"), we will pay the Centre for a term of three years from September 9, 1999, an annual amount of RMB110,000,000, for the provision of the services, including: o geophysical exploration services; o seismic data processing; o comprehensive exploration research services; and o information technology services. (d) Lease agreements We have entered into lease agreements with affiliates of CNOOC for the leasing of various office, warehouse and residential premises for a three-year term commencing September 9, 1999. Lease charges are based on market rates. (e) Sales of crude oil, condensate oil and liquefied petroleum gas We sold crude oil, condensate oil and liquefied petroleum gas to CNOOC's affiliates which engage in the downstream petroleum business at the international market price. For the year ended December 31, 2001, the total sales amounted to approximately RMB1,814,197,000 (2000: RMB507,677,000, 1999: RMB117,000,000). The following is a summary of our significant recurring transactions carried out in the ordinary course of business with CNOOC and its affiliates. 1999 2000 2001 ----------------- ---------------- -----------------

RMB'000 RMB'000 RMB'000 Included in exploration costs: Provision for geological and geophysical services 127,290 55,295 139,659 Provision for research and development services 76,500 109,880 89,999 Provision for drilling services 35,046 106,150 389,847 Included in operating expenses: Provision for technological services 211,326 254,276 44,044 Provision for research and development services 38,220 51,853 29,587 Provision for oil transportation services 263,061 171,490 68,399 Provision for production related services 570,219 597,579 579,207 Provision for materials, utilities and ancillary services 90,177 163,828 148,149 Included in selling and administrative expenses: Rental for office lease 12,459 49,089 45,524 Provision for research and development services - - 40,763 Provision for other ancillary services - 31,748 87,557 Included in interest income and expenses: Interest income from a related company 117 25 - Interest expense to CNOOC 6,225 41,500 8,415 Capitalized under property, plant and equipment: Provision for oil and gas property construction services 679,000 865,549 1,341,545 Provision for drilling services 456,717 445,414 285,834 Provision for well measurement services 101,392 140,065 97,633 F-35 27. RELATED PARTY TRANSACTIONS (CONT'D) In addition to the recurring transaction described above, pursuant to a conditional agreement dated August 27, 2001, we will acquire interest in certain oil and natural gas fields in the Xihu Trough in the East China Sea of the PRC from CNOOC for a total consideration of US$45,000,000. As of December 31, 2001, the transaction has not been completed and the legal title of the reserves has not been passed to us. The amount paid was recorded as prepayments which is included in other current assets in the balance sheet. 28. COMMITMENTS AND CONTINGENCIES (a) Capital commitments As of December 31, 2001 and 2000, we have the following capital commitments, principally for the construction and purchases of property, plant and equipment: 2000 2001 ----------------- ------------------ RMB'000 RMB'000 Contracted for 3,325,216 1,606,700 Authorized but not contracted for 7,729,113 5,183,690 As of December 31, 2001 and 2000, we had unutilized banking facilities amounted to approximately RMB7,599,371,000 and RMB15,146,544,000 respectively to finance development of oil and gas properties. We had no significant contingent liabilities as of December 31, 2001 and 2000. (b) Research and development commitment According to the research and development services agreement with the Centre, we agreed to pay the Centre for a term of three years from September 9, 1999, an annual amount of RMB110,000,000 for provision of general geophysical exploration services, comprehensive exploration research services, information technology services and seismic data processing. As of December 31, 2001 and 2000, commitments for research and development services to be provided by the Centre amounted to approximately RMB83,382,500 and RMB192,472,500 respectively. (c) Operating lease commitments Operating lease commitments as of December 31, 2001 and 2000 amounted to approximately RMB94,079,000 and RMB143,922,000 and were as follows: 2000 2001 ----------------- ------------------ RMB'000 RMB'000 Commitment due: - Within one year 49,843 48,789 - After one year but within two years 48,789 45,290 - After two years but within three years 45,290 - ----------------- ------------------ 143,922 94,079 ================= ================== F-36 28. COMMITMENTS AND CONTINGENCIES (CONT'D) (d) Commitment to invest in the development of Australia's gas project In August 2001, we signed a Memorandum of Understanding to explore the feasibility of acquiring an equity interest in oil and gas assets in a large natural gas field in Australia, and to develop the natural gas market in coastal China. In November 2001, we entered into a Heads of Agreement on a joint venture to develop Northwest Shelf gas in Australia. We agreed to co-invest in the development of Australia's Northwest Shelf gas project and to produce and process liquefied natural gas to sell to the China markets, subject to the joint venture successfully bidding for the contract to supply liquefied natural gas to an import facility in Guangdong Province, in which CNOOC, the parent company, has an equity interest. 29. FINANCIAL INSTRUMENTS (a) Currency swap contracts As of December 31, 2001 and 2000, we had currency swap contracts with a financial institution to sell United States dollars in exchange for Japanese Yen in order to hedge against future repayments of certain Japanese Yen denominated loans. The hedged Japanese Yen loans bore interest at fixed rate of 4.5% per annum. The interest stipulated in the swap contract for the United States dollars was floating LIBOR rate. The details are as follows: 2000 2001 ---------------------------------- --------------------------------- Weighted Weighted Notional average Notional average contract contractual contract contractual amount exchange rate amount exchange rate -------------- ----------------- ------------- -------------------- (JPY'000) (JPY/US$) (JPY'000) (JPY/US$) Year 2001 271,470 95.00 - - 2002 271,470 95.00 271,470 95.00 2003 271,470 95.00 271,470 95.00 2004 271,470 95.00 271,470 95.00 2005 271,470 95.00 271,470 95.00 2006 271,470 95.00 271,470 95.00 2007 271,470 95.00 271,470 95.00 (b) Fair value of financial instruments The carrying amounts of cash and cash equivalents, time deposits and short-term investments approximated fair value due to the short maturity of these instruments. The estimated fair value of long-term bank loans based on current market interest rates for comparable instruments approximated their book value. 30. F-37 CONCENTRATION OF RISKS (a) Credit risk The carrying amount of cash and cash equivalents, time deposits, accounts receivable and other receivables, and due from related parties and other current assets except for prepayments represents our maximum exposure to credit risk in relation to financial assets. The majority of our accounts receivable is related to sales of oil and natural gas to third party customers. We perform ongoing credit evaluations of our customers' financial condition and generally do not require collateral on accounts receivable. We maintain a provision for doubtful accounts and actual losses have been within management's expectation. No other financial assets carry a significant exposure to credit risk. (b) Interest rate risk Our directors believe that the exposure to interest rate risk of financial assets and liabilities as of December 31, 2001 was minimum since their deviation from their respective fair values was not significant. The interest rates and terms of repayment of our long-term bank loans are disclosed in Note 18. (c) Currency risk Substantially all of the revenue-generating operations of us are transacted in RMB, which is not freely convertible into foreign currencies. On January 1, 1994, the Mainland China government abolished the dual rate system and introduced single rate of exchange as quoted by the People's Bank of China. However, the unification of the exchange rate does not imply free convertibility of RMB into foreign currencies. As foreign exchange transactions continue to take place either through the People's Bank of China or other banks authorized to buy and sell foreign currencies at the exchange rates quoted by the People's Bank of China, approval of foreign currency payment by the People's Bank of China or other institution requires submitting a payment application form together with suppliers' invoices, shipping documents and signed contracts. (d) Business risk We conduct our major operations in the PRC and accordingly are subject to special considerations and significant risks not typically associated with investments in equity securities of the United States of America and Western European companies. These include risks associated with, among others, the oil and gas industry, the political, economic and legal environments, influence of the national authorities over price setting and competition in the industry. F-38 30. CONCENTRATION OF RISKS (CONT'D) (e) Customer risk A substantial portion of our oil and gas sales is made to a small number of customers on an open account basis. 1999 2000 2001 ---------------- ---------------- ---------------- RMB'000 RMB'000 RMB'000 China Petroleum & Chemical Corporation 8,597,541 6,325,061 6,282,532 PetroChina Company Limited 1,836,924 1,458,429 1,320,587 Castle Peak Power Company Limited 1,162,583 1,199,090 1,205,649 31. NOTES TO CASH FLOW STATEMENTS (a) The reconciliation of income before taxation to net cash inflow from operating activities is as follows: 1999 2000 2001 ---------------- ---------------- ---------------- RMB'000 RMB'000 RMB'000 Income before taxation 4,833,364 12,222,676 11,005,858 Adjustments for: Depreciation, depletion and amortization 2,373,380 2,577,882 2,566,920 Impairment losses related to property, plant and equipment - - 99,675 Recovery of doubtful accounts (5,382) (57,658) (4,966) Profit of an associated company (13,301) (218,326) (89,963) Loss on disposal and written off of property, plant and equipment - 220,146 456,827 Dismantlement and site restoration allowance 177,090 103,569 90,367 Short-term investment income - - (220,650) Interest income (53,709) (236,624) (317,706) Interest expense 621,704 475,004 116,634 Exchange loss (gain), net 402,529 (324,178) (261,305) ---------------- ---------------- ---------------- Operating profit before working capital changes 8,335,675 14,762,491 13,441,691 Decrease in accounts receivable (1,928,492) 1,146,613 726,976 (Increase) decrease in inventories and supplies (124,677) (2,438) 35,422 Increase in other current assets (1,791) (39,386) (447,473) Increase (decrease) in accounts payable and accrued liabilities 1,583,840 (1,440,278) 379,233 Increase (decrease) in other taxes payable 307,291 2,701 (110,867) ---------------- ---------------- ---------------- Net cash inflow from operating activities 8,171,846 14,429,703 14,024,982 ================ ================ ================ F-39 31. NOTES TO CASH FLOW STATEMENTS (CONT'D) (b) Analysis of changes in financing during the years: Paid-in capital Due to and share Due to parent related premium Bank loans company companies ---------------- ------------- --------------- ---------------- RMB'000 RMB'000 RMB'000 RMB'000 Proceeds from bank loans - 813,965 - - Repayments of bank loans - (2,143,892) - - Net repayments of loans - - (786,412) - Net proceeds from loans - - - 159,844 Return of capital to CNOOC (471,560) - - - Balances at January 1, 1999 2,485,762 10,030,187 877 136,985 Effect of changes in foreign exchange rates 99 402,529 - - Transfer from reserves 5,752,654 - - - Accrual for pension and distribution to CNOOC - - 2,399,665 - ---------------- ------------- --------------- ---------------- Balances at January 1, 2000 7,766,955 9,102,789 1,614,130 296,829 Proceeds from short-term bank loans - 339,423 - - Repayments of bank loans - (3,371,657) - - Net proceeds from Private Placements 3,769,664 - - - Net proceeds from loans - - 47,256 - Net repayments of loans - - - (164,570) Effect of changes in foreign exchange rates - (324,178) - - Properties transferred from CNOOC - - 121,111 - ---------------- ------------- --------------- ---------------- Balances at January 1, 2001

11,536,619 5,746,377 1,782,497 132,259 Proceeds from short-term bank loans - 2,500,000 - - Repayments of bank loans - (3,497,533) - - Net proceeds from issue of ordinary shares 10,101,564 - - - Net prepayments of loans - - (1,657,004) - Net proceeds from loans - - - 25,564 Effect of changes in foreign exchange rates - (261,305) - - ----------------- -------------- --------------- ----------------- Balances at December 31, 2001 21,638,183 4,487,539 125,493 157,823 ================= ============== =============== ================= 32. SEGMENT INFORMATION (a) Business segments We are involved in the upstream operating activities of the petroleum industry that comprise production sharing contracts with foreign partners, independent operations and trading business. These segments are determined primarily because the senior management makes key operating decisions and assesses performance of the segments separately. The accounting policies of our segments are the same as those described in the principal accounting policies in Note 3. We evaluates performance based on profit or loss from operations before income taxes. F-40 32. SEGEMENT INFORMATION (CON'D) An analysis by business segment is as follows: Independent operations Production sharing contracts -- --- 1999 2000 2001 1999 2000 2001 -- --- RMB'000 RMB'000 RMB'000 RMB'000 RMB'000 RMB'000 TURNOVER Sales to external customers: Oil and Gas sales 4,588,391 9,283,228 9,845,019 4,968,822 8,859,606 7,023,926 Marketing revenues - - - - - - Intersegment revenues - - - 1,840,660 676,489 691,843 Other income 44,700 161,790 558,368 56,757 107,390 123,312 ---------- ---------- ---------- ---------- ---------- ---------- 4,633,091 9,445,018 10,403,387 6,866,239 9,643,485 7,839,081 ========== ========== ========== ========== ========== ========== RESULTS Operating expenses (538,665) (894,813) (1,183,252) (1,316,644) (1,229,265) (1,145,878) Production taxes (254,466) (526,491) (525,454) (324,412) (510,238) (355,544) Exploration costs (244,378) (523,633) (955,475) (2,024) (29,236) (83,822) Depreciation, depletion and amortization (806,720) (1,443,045) (1,531,184) (1,566,660) (1,130,820) (1,035,736) Dismantlement and site restoration allowances (54,672) (49,145) (41,530) (122,418) (54,424) (48,837) Impairment losses related to property, plant and equipment - - (60,907) - - (38,768) Crude oil and product purchases - - - - - - Selling and administrative expenses (16,502) (33,146) (35,686) - (99) (100) Other - (133,976) (514,655) - - - Interest income - - - - - - Interest expense (283,687) (262,274) (69,437) (295,798) (171,230) (13,871) Exchange (loss) gain, net - - - - - - Investment income - - - - - - Share of profits of an associated company - - - - - - Non-operating (loss) income, net 2 (221,442) 18,267 - - - Provision for taxation - - - - - - ---------- ---------- ---------- ---------- ---------- ---------- Net income 2,434,003 5,357,053 5,504,074 3,238,283 6,518,173 5,116,525 ========== ========== ========== ========== ========== ========== OTHER INFORMATION Capital expenditures 3,626,737 3,326,893 1,922,074 691,577 1,244,159 2,398,601 ========== ========== ========== ========== ========== ========== Independent operation Production sharing contract ------------------------------- ------------------------------- 2000 2001 2000 2001 ------------------------------- ------------------------------- RMB'000 RMB'000 RMB'000 RMB'000 Segment assets 15,592,100 15,422,016 9,829,861 10,295,857 Investment in equity method associate - - - - TOTAL ASSETS 15,592,100 15,422,016 9,829,861 10,295,857 SEGMENT LIABILITIES 4,795,521 4,254,418 3,878,273 3,372,175 Trading business --- 1999 2000 2001 --- RMB'000 RMB'000 RMB'000 TURNOVER Sales to external customers: Oil and Gas sales - - - Marketing revenues 5,645,027 5,802,504 3,228,875 Intersegment revenues - - - Other income - - - ---------- ---------- ---------- 5,645,027 5,802,504 3,228,875 ========== ========== ========== RESULTS Operating expenses - - - Production taxes - - - Exploration costs - - - Depreciation, depletion and amortization - - - Dismantlement and site restoration allowances - - - Impairment losses related to property, plant and equipment - - - Crude oil and product purchases (5,577,331) (5,774,254) (3,145,155) Selling and administrative expenses - - - Other - - - Interest income - - - Interest expense - - - Exchange (loss) gain, net - - - Investment income - - - Share of profits of an associated company - - - Non-operating (loss) income, net - - - Provision for taxation - - - ---------- ---------- ---------- Net income 67,696 28,250 83,720 ========== ========== ========== OTHER INFORMATION Capital expenditures - - - ========== ========== ========== Trading business ------------------------------ 2000 2001 ------------------------------ RMB'000 RMB'000 Segment assets - 368,670 Investment in equity method associate - - TOTAL ASSETS - 368,670 SEGMENT LIABILITIES - 106,862 Unallocated Eliminations -------------------------------------- --- 1999 2000 2001 1999 2000 2001 ---------- ---------- --------- ----------- ---------- --------- RMB'000 RMB'000 RMB'000 RMB'000 RMB'000 RMB'000 TURNOVER Sales to external customers: Oil and Gas sales - - - - - - Marketing revenues - - - - - - Intersegment revenues - - - (1,840,660) (676,489) (691,843) Other income 6,890 9,400 40,057 - - - --------- --------- --------- --------- --------- ---------- 6,890 9,400 40,057 (1,840,660) (676,489) (691,843) --------- --------- --------- ---------- ---------- ---------- RESULTS Operating expenses - - - - - - Production taxes - - (2,770) - - - Exploration costs - - - - - - Depreciation, depletion and amortization - (4,017) - - - - Dismantlement and site - - - - - - restoration allowances - - - - - - Impairment losses related to - - - - - - property, plant and equipment - - - - - - Crude oil and product purchases - - - 1,840,660 676,489 691,843 Selling and administrative exepenses (499,983) (422,757) (579,603) - - - Other (5,423) (83,623) (3,221) - - - Interest income 53,709 236,624 317,706 - - - Interest expense (42,219) (41,500) (33,326) - - - Exchange (loss) gain, net (431,980) 381,336 235,409 - - - Investment income - 220,650 - - - Share of profits of an - - - - - - associated company 13,301 218,326 89,963 - - - Non-operating (loss) income, net (913) 25,411 16,674 - - - Provision for taxation (721,925) (1,926,076) (3,048,227 - - - ---------- --------- --------- --------- --------- -------- Net income (1,628,543) (1,606,876 (2,746,688 - - - ========== ========= ========= ========== ========= ======== OTHER INFORMATION Capital expenditures - 13,291 18,063 - - - ========== ========= ========= ========== ========= ======== Unallocated Eliminations ------------------------------ ------------------------------ 2000 2001 2000 2001 ------------------------------ RMB'000 RMB'000 RMB'000 RMB'000 Segment assets 6,704,417 17,771,115 - - Investment in equity method associate 471,027 461,990 - - TOTAL ASSETS 7,175,444 18,233,105 - - SEGMENT LIABILITIES 7,801,808 3,275,687 - - Totals -- 1999 2000 2001 -------------- ------------ -------------- RMB'000 RMB'000 RMB'000 TURNOVER Sales to external customers: Oil and Gas sales Marketing revenues 9,557,213 18,142,834 16,868,945 Intersegment revenues 5,645,027 5,802,504 3,228,875 Other income - - - 108,347 278,580 721,737 ---------- ---------- ---------- RESULTS 15,310,587 24,223,918 20,819,557 Operating expenses ---------- ---------- ---------- Production taxes Exploration costs (1,855,309) (2,124,078 (2,329,130) Depreciation, depletion and (578,878) (1,036,729) (883,768) amortization (246,402) (552,869) (1,039,297) Dismantlement and site (2,373,380) (2,577,882 (2,566,920) restoration allowances (90,367) Impairment losses related to (177,090) (103,569) property, plant and equipment - - (99,675) Crude oil and product purchases (3,736,671) (5,097,765) (2,453,312) Selling and administrative exepenses (516,485) (456,002) (615,389) Other (5,423) (217,599) (517,876) Interest income 53,709 236,624 317,706 Interest expense (621,704) (475,004) (116,634) Exchange (loss) gain, net (431,980) 381,336 235,409 Investment income - - 220,650 Share of profits of an associated company 13,301 218,326 89,963 Non-operating (loss) income, net (911) (196,031) 34,941 Provision for taxation (721,925) (1,926,076 (3,048,227) ---------- --------- --------- Net income 4,111,439 10,296,600 7,957,631 ========== ========== ========== OTHER INFORMATION Capital expenditures 4,318,314 4,584,343 4,338,738 ========== ========== =========== Total ------------------------------- 2000 2001 ------------------------------- RMB'000 RMB'000 32,126,378 43,857,658 471,027 461,990 32,597,405 44,319,648 16,475,602 11,009,142 F-41 32. SEGMENT INFORMATION (CONT'D) (b) Geographical segments We are an oil and gas company engaged in the exploration, development and production of crude oil and natural gas offshore China. Approximately 87% of our total revenue is contributed by PRC customers, therefore, our activities are conducted predominantly in the PRC. An analysis by geographical segment is as follows: PRC Outside PRC Total --------------------------------- --------------------------------- --------------------------------- 1999 2000 2001 1999 2000 2001 1999 2000 2001 ---------- ---------- ---------- ---------- ---------- ---------- ---------- ---------- ---------- RMB'000 RMB'000 RMB'000 RMB'000 RMB'000 RMB'000 RMB'000 RMB'000 RMB'000 External sales 11,140,229 17,559,042 18,104,658 4,170,358 6,664,876 2,714,899 15,310,587 24,223,918 20,819,557 Capital expenditures 4,318,284 4,566,554 4,311,241 30 17,789 27,497 4,318,314 4,584,343 4,338,738 PRC Outside PRC Total --------------------- --------------------- --------------------- 2000 2001 2000 2001 2000 2001 ---------- ---------- ---------- ---------- ---------- ---------- RMB'000 RMB'000 RMB'000 RMB'000 RMB'000 RMB'000 Segment assets 32,432,338 43,783,409 165,067 536,239 32,597,405 44,319,648 (c) An analysis of sales to the major customers by segment is as follows: 1999 2000 2001 ----------------- ----------------- ----------------- RMB'000 RMB'000 RMB'000 Production sharing contracts China Petroleum & Chemical Corporation 5,733,935 1,850,239 2,861,847 PetroChina Company Limited 1,402,154 690,853 1,126,127 Castle Peak Power Company Limited 1,162,583 1,199,090 1,205,649 ----------------- ----------------- ----------------- 8,298,672 3,740,182 5,193,623 ----------------- ----------------- ----------------- Independent operations China Petroleum & Chemical Corporation 2,863,606 4,474,822 3,420,685 PetroChina Company Limited 434,770 767,576 194,460 ----------------- ----------------- ----------------- 3,298,376 5,242,398 3,615,145 ----------------- ----------------- ----------------- 11,597,048 8,982,580 8,808,768 ================= ================= ================= F-42 33. SUBSEQUENT EVENTS (i) On January 18, 2002, CNOOC Southeast Asia Limited entered into a share purchase agreement to acquire shares and intercompany loans of nine subsidiaries of Repsol-YPF, S.A. The nine subsidiaries together hold a portfolio of operating and non-operating interests in oil and gas production sharing and technical assistance contracts in contract areas located offshore and onshore Indonesia. The aggregate consideration for the shares and intercompany loans is US$585,000,000. The assets to be acquired include a 65.3% interest in the Offshore Southeast Sumatra Contract Area production sharing contract, a 36.7% interest in the Offshore Northwest Java Contract Area production sharing contract, a 25% interest in the West Madura Offshore Block production sharing contract, a 50% interest in the Poleng Field technical assistance contract and a 16.7% interest in the Blora Block production sharing contract. The acquisition is expected to be completed on or before September 30, 2002. We would act as guarantor of CNOOC Southeast Asia Limited's obligations under the acquisition. (ii) Bond issue and establishment of CNOOC Finance (2002) Company On March 1, 2002, CNOOC Finance (2002) Limited, a company incorporated in the British Virgin Islands on January 24, 2002 and a wholly owned subsidiary of us, issued US$500,000,000 principal amount of 6.375% guaranteed notes due 2012. The obligations of CNOOC Finance (2002) Limited in respect of the notes are unconditionally and irrevocably guaranteed by us. (iii) Dividends On March 27, 2002, the board of directors proposed a final dividend of HK$0.15 per share, totaling HK$1,232,124,848 (Equivalent to RMB1,306,791,614) to our shareholders for the year ended December 31, 2001. The proposed dividend distribution is subject to shareholders approval in their next meeting. 34. ULTIMATE HOLDING COMPANY Our directors consider CNOOC, a company established in the PRC, as the ultimate holding company. 35. ADDITIONAL FINANCIAL INFORMATION As of December 31, 2001, our net current assets and total assets less current liabilities amounted to approximately RMB15,638,483,000 (2000: RMB704,228,000) and RMB39,927,972,000 (2000: RMB23,829,630,000), respectively. F-43 36. SIGNIFICANT DIFFERENCES BETWEEN HONG KONG GAAP AND U.S. GAAP The accounting policies adopted by us conform to Hong Kong GAAP, which differ in certain respects from generally accepted accounting principles in the United States of America ("U.S. GAAP"). (a) Net income and net equity (i) Revaluation of land and buildings We revalued certain land and buildings on August 31, 1999 as part of the Reorganization. We have recorded the revaluation surplus on that date. On December 31, 2000, we revalued such properties and related revaluation surplus of approximately RMB104,073,000 had been recorded on that date. Under Hong Kong GAAP, revaluation of property, plant and equipment is permitted and depreciation, depletion and amortization are based on the revalued amount. Additional depreciation arising from the revaluation was approximately RMB1,896,000 for the period from September 1, 1999 to December 31, 1999, RMB5,687,000 for the year ended December 31, 2000 and RMB9,156,000 for the year ended December 31, 2001. Under U.S. GAAP, property, plant and equipment is required to be stated at cost. Hence, no additional depreciation, depletion and amortization from the revaluation is recognized under U.S. GAAP. (ii) Short-term investments According to Hong Kong GAAP, available-for-sale investments in marketable securities are measured at fair value and related unrealized holding gains and loses are included in current period earnings. According to U.S. GAAP, such investments are also measured at fair value and classified in accordance with Statement of Financial Accounting Standards ("SFAS") No. 115. Under U.S. GAAP, related unrealized gains and losses are excluded from current period earnings reported. (iii) Impairment of long-lived assets Under Hong Kong GAAP, impairment charges are recognized when a long-lived asset's carrying amount exceeds the higher of an asset's net selling price and value in use, which incorporates discounting the asset's estimated future cash flows. Under U.S. GAAP, long-lived assets are assessed for possible impairment in accordance with SFAS No. 121, "Accounting for the Impairment of Long-lived assets and for Long-lived Assets to Be Disposed Of". SFAS No. 121 requires us to assess the need for an impairment of capitalized costs of proved oil and gas properties and the costs of wells and related equipment and facilities on a property-by-property basis. If an impairment is indicated based on undiscounted expected future cash flows, then an impairment is recognized to the extent that net capitalized costs exceed the estimated fair value of the property. We estimate the fair value of the property using the present value of future cash flows discounted at 10%. The impairments were determined based on the difference between the carrying value of the assets and the present value of future cash flows discounted at 10%. It is reasonably possible that a change in reserve or price estimates could occur in the near term and adversely impact management's estimate of future cash flows and consequently the carrying value of properties. F-44 36. SIGNIFICANT DIFFERENCES BETWEEN HONG KONG GAAP AND U.S. GAAP (CONT'D) (a) Net income and net equity (Cont'd) In addition, under Hong Kong GAAP, a subsequent increase in the recoverable amount of an asset is reversed to the statement of income to the extent that an impairment loss on the same asset was previously recognized as an expense when the circumstances and events that led to the write-down or write-off cease to exist. The reversal is reduced by the amount that would have been recognized as depreciation had the write-off not occurred. Under U.S. GAAP, an impairment loss establishes a new cost basis for the impaired asset and the new cost basis should not be adjusted subsequently other than for further impairment losses. For the year ended December 31, 2001, there were no difference on the amounts of impairment loses recognized under Hong Kong GAAP and U.S. GAAP and no reversal of the recovery of previous impairment charges recorded under Hong Kong GAAP. (iv) Stock compensation plans As described in Note 24 to the financial statements, as of December 31, 2001, we had two stock option plans. We apply Accounting Principles Board Opinion 25 and related Interpretations in accounting for these stock option plans. Accordingly, compensation costs that have been recognized for the stock option plans were RMB2,755,000 for the year ended December 31, 2001. Had compensation costs for our stock option plans been determined based on the fair value at the grant dates for awards under the plans consistent with the method of SFAS No.123, our net income and earnings per share for the year ended December 31, 2001 would have been reduced to the pro forma amounts indicated below: As reported Pro forma ---------------- ---------------- Net income (RMB'000) 7,920,236 7,912,150 Earnings per share - Basic RMB1.00 RMB1.00 - Diluted RMB1.00 RMB1.00 Weighted average fair value of the options at the grant dates for awards under the plans was RMB3.10 per share which was estimated using the Black-Scholes model with the following assumptions: dividend yield of 2.0%, an expected life of 5 years; expected volatility of 44%; and risk-free interest rates of 5.25%. Weighted average exercise price of the stock options was HK$6.09 per share. F-45 36. SIGNIFICANT DIFFERENCES BETWEEN HONG KONG GAAP AND U.S. GAAP (CONT'D) (a) Net income and net equity (Cont'd) Effects on net income and net equity of above significant differences between Hong Kong GAAP and U.S. GAAP are summarized below: Net income -- 1999 2000 2001 ------------------ ------------------ ------------------ RMB'000 RMB'000 RMB'000 As reported under Hong Kong GAAP 4,111,439 10,296,600 7,957,631 Impact of U.S. GAAP adjustments: - Reversal of additional depreciation, depletion and amortization arising from the revaluation surplus on land and buildings 1,896 5,687 9,156 - Unrealized holding gains from available-for-sale investments in marketable securities - - (43,796) - Recognition of stock compensation cost - - (2,755) ------------------ ------------------ ------------------ As restated under U.S. GAAP 4,113,335 10,302,287 7,920,236 ================== ================== ================== Net income per share under U.S. GAAP - Basic RMB 0.69 RMB 1.63 RMB 1.00 ================== ================== ================== - Diluted RMB 0.69 RMB 1.63 RMB 1.00 ================== ================== ================== Net equity -- 2000 2001 ------------------- ------------------- RMB'000 RMB'000 As reported under Hong Kong GAAP 16,121,803 33,310,506 Impact of U.S. GAAP adjustments: - Reversal of revaluation surplus on land and buildings (274,671) (274,671) - Reversal of additional accumulated depreciation, depletion and amortization charges arising from the revaluation surplus on land and buildings 7,583 16,739 ------------------- ------------------- As restated under U.S. GAAP 15,854,715 33,052,574 =================== =================== There are no significant GAAP differences that affect classifications within the balance sheet or statement of income but do not affect net income or shareholders' equity. F-46 36. SIGNIFICANT DIFFERENCES BETWEEN HONG KONG GAAP AND US GAAP (CONT'D) (b) Statement of cash flows We apply Hong Kong SSAP 15 "Cash Flow Statements". Its objectives and principles are similar to those set out in SFAS No. 95, "Statement of Cash Flows". The principal differences between the standards relate to classification. Under Hong Kong SSAP 15, we present our cash flows for (a) operating activities; (b) returns on investments and servicing of finance; (c) taxation; (d) investing activities; and (e) financing. Cash flows from taxation and returns on investments and servicing of finance would be included as operating activities under SFAS No. 95, with the exception of distributions, which under SFAS No. 95 would be classified as financing activities. Summarized cash flow data by operating, investing and financing activities in accordance with SFAS No. 95 are as follows: 1999 2000 2001 ----------------- ----------------- ----------------- RMB'000 RMB'000 RMB'000 Net cash inflow (outflow) from: - Operating activities 7,323,219 13,232,701 11,759,457 - Investing activities (4,442,058) (7,860,606) (11,366,434) - Financing activities (2,428,055) (3,454,350) 3,204,074 ----------------- ----------------- ----------------- Changes in cash and cash equivalents 453,106 1,917,745 3,597,097 Cash and cash equivalents at beginning of year 425,776 878,882 2,796,627 ----------------- ----------------- ----------------- Cash and cash equivalents at end of year 878,882 2,796,627 6,393,724 ================= ================= ================= (c) Comprehensive income According to SFAS No. 130, it is required to include a statement of other comprehensive income for revenues and expenses, gains and losses that under

U.S. GAAP are included in comprehensive income and excluded from net income. 1999 2000 2001 ---------------- ----------------- ----------------- RMB'000 RMB'000 RMB'000 Net income under U.S. GAAP 4,113,335 10,302,287 7,920,236 Other comprehensive income: Foreign currency translation adjustments 99 (6,350) 702 Unrealized gains on short-term investments - - 43,796 ---------------- ---------------- ----------------- Comprehensive income under U.S. GAAP 4,113,434 10,295,937 7,964,734 ================ ================= ================= Roll forward of accumulated other comprehensive income components are as follows: Foreign currency Unrealized gains Accumulated other translation on short-term comprehensive adjustments investments income ------------------- ------------------- ------------------- RMB'000 RMB'000 RMB'000 Balance at January 1, 2000 - - - Current year change (6,350) - (6,350) ------------------- ------------------- ------------------- Balance at January 1, 2001 (6,350) - (6,350) Current year change 702 43,796 44,498 ------------------- ------------------- ------------------- Balance at December 31, 2001 (5,648) 43,796 38,148 =================== =================== =================== F-47 36. SIGNIFICANT DIFFERENCES BETWEEN HONG KONG GAAP AND U.S. GAAP (CONT'D) (d) Derivative instruments We had a currency swap contract with a financial institution to sell United States dollars in exchange for Japanese Yen in order to hedge certain Japanese Yen denominated loan repayments in the future. In accordance with SFAS No.133, the derivative contract was recorded as "other current liabilities" in the consolidated balance sheet at fair value. For the year ended December 31, 2001, we recognized related changes in fair value, a loss of RMB29,134,000, and included the amount in "exchange gain, net" in the consolidated statement of income. The adoption of SFAS No. 133 as of January 1, 2001 had no impact on our financial statements. (e) Use of estimates in the preparation of financial statements The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. The most significant estimates pertain to proved oil and gas reserve volumes and the future development, dismantlement and abandonment costs as well as estimates relating to certain oil and gas revenues and expenses. Actual amounts could differ from those estimates and assumptions. (f) Deferred income taxes Under Hong Kong GAAP, we provide deferred taxes for timing differences only to the extent that it is probable that a liability or asset will crystallize in the foreseeable future. U.S. GAAP requires full provision for deferred taxes under the asset and liability method on all temporary differences. For Hong Kong GAAP purposes, deferred taxes are provided using the liability method whereby it is calculated using tax rates estimated to be applicable when timing differences reverse. For U.S. GAAP purposes, deferred tax assets and liabilities are recognized for the expected future tax consequences of existing differences between financial reporting and tax reporting bases of assets and liabilities, and loss or tax credit carryforwards using enacted tax rates expected to be in effect when these differences are realized. Valuation allowances are recorded for deferred tax assets for which it is more likely than not that such assets will be realized. For the year ended December 31, 2001, there was no difference on the amounts of deferred income taxes recognized under Hong Kong GAAP and U.S. GAAP. (g) Segment reporting Our segment information is based on the segmental operating results regularly reviewed by our chief operating decision maker. The accounting policies used are the same as those used in the preparation of our consolidated Hong Kong GAAP financial statements. F-48 36. SIGNIFICANT DIFFERENCES BETWEEN HONG KONG GAAP AND U.S. GAAP (CONT'D) (h) Newly issued accounting standards (i) SFAS No. 141 "Business Combinations" In June 2001, SFAS No. 141 "Business Combinations" was released. This statement addresses financial accounting and reporting for business combinations and requires that the purchase method of accounting to be used for all business combinations initiated or with the acquisition date after June 30, 2001. The adoption of the statement is not expected to have a significant effect on our financial statements. (ii) SFAS No. 143 "Accounting for Asset Retirement Obligations" On August 15, 2001, SFAS No. 143 "Accounting for Asset Retirement Obligations" was released and will be effective for the fiscal years beginning after June 15, 2002. This statement requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived assets. Further, under this statement, the liability is discounted and accretion expense is recognized using the credit-adjusted risk-free interest rate in effect when the liability was initially recognized. According to the existing accounting policies adopted to prepare the financial statements, we estimate future dismantlement and site restoration costs for oil and gas properties with reference to the estimates provided from either internal or external engineers after taking into consideration the anticipated method of dismantlement and the extent of site restoration required in accordance with current legislation and industry practice. We provide for the future dismantlement and site restoration allowance using the unit of production method over the useful life of the related asset. Adoption of the statement will likely result in increase in both costs of assets and total liabilities. We are currently assessing these matters and have not yet determined whether or the extent to which they will affect the financial statements. (iii) SFAS No. 144 "Accounting for the Impairment or Disposal of Long-lived Assets" In August 2001, SFAS No. 144 "Accounting for the Impairment or Disposal of Long-lived Assets" was released and will be effective for the fiscal years beginning after December 15, 2001. This statement retains the requirements of SFAS No. 121 to (a) recognize an impairment loss only if the carrying amount of a long-lived asset is not recoverable from its undiscounted cash flows and (b) measure an impairment loss as the difference between the carrying amount and fair value of the asset. This statement requires that a long-lived asset to be abandoned, exchanged for a similar productive asset, or distributed to owners in a spinoff be considered held and used until it is disposed of. The accounting model for long-lived assets to be disposed of by sale is used for all long-lived assets, whether previously held and used or newly acquired. That accounting model retains the requirement of SFAS No. 121 to measure a long-lived asset classified as held for sale at the lower of its carrying amount or fair value less cost to sell and to cease depreciation. Therefore, discontinued operations are no longer measured on a net realizable value basis, and future operating losses are no longer recognized before they occur. The changes in this statement improve financial reporting by requiring that one accounting model be used for long-lived assets to be disposed of by sale, whether previously held and used or newly acquired, and by broadening the presentation of discontinued operations to include more disposal transactions. The adoption of the statement is not expected to have a significant effect on our financial statements. F-49 SUPPLEMENTARY INFORMATION ON OIL AND GAS PRODUCING ACTIVITIES (UNAUDITED) The following disclosures are included in accordance with the United States Statements of Financial Accounting Standards No. 69, "Disclosures about Oil and Gas Producing Activities". (a) Reserve quantity information Crude oil and natural gas reserve estimates are determined through analysis of geological and engineering data which appear, with reasonable certainty, to be recoverable at commercial rates in the future from known oil and natural gas reservoirs under existing economic and operating conditions. Estimates of crude oil and natural gas reserve have been made by independent engineers and our internal engineers. Our net proved reserves consist of our percentage interest in reserves, comprised of a 100% interest in our independent oil and gas properties and our participating interest in the properties covered under the production sharing contracts, less (a) an adjustment for our share of royalties payable by us to the PRC government and our participating interest in share oil payable to the PRC government under the production sharing contracts, and less (b) an adjustment for production allocable to foreign partners under the production sharing contracts as reimbursement for exploration expenses attributable to our participating interest. Proved developed and undeveloped reserves (net of royalties and government share oil): Oil* Natural gas ----------------- ----------------- (mmbls) (bcf) December 31, 1998 1,176 3,396 Discoveries and extensions 144 14 Production (64) (74) Revisions of prior estimates (14) (4) ------------------ ------------------ December 31, 1999 1,242 3,332 Discoveries and extensions 76 5 Sales of reserves (41) - Production (75) (72) Revisions of prior estimates 14 (15) ----------------- ----------------- December 31, 2000 1,216 3,250 Discoveries and extensions 199 166 Production (84) (71) Revisions of prior estimates (52) (97) ------------------ ------------------ December 31, 2001 1,279 3,248 ================== ================== -------------- * Crude oil and natural gas liquids, including 33mmbls reserve estimated by our internal engineers. Proved developed reserves: Oil* Natural gas ------------------ ------------------ (mmbls) (bcf) December 31, 1999 358 608 December 31, 2000 546 558 December 31, 2001 582 765 -------------- * Crude oil and natural gas liquids. F-50 SUPPLEMENTARY INFORMATION ON OIL AND GAS PRODUCING ACTIVITIES (UNAUDITED) (CONT'D) (b) Results of operations 1999 2000 2001 ----------------- ----------------- ------------------ RMB'000 RMB'000 RMB'000 Net sales to customers 11,397,873 18,819,323 17,560,788 Operating expenses (1,855,309) (2,124,078) (2,329,130) Production taxes (578,878) (1,036,729) (883,768) Exploration costs (246,402) (552,869) (1,039,297) Depreciation, depletion and amortization (2,373,380) (2,577,882) (2,566,920) ----------------- ----------------- ------------------ Results of operations before tax 6,343,904 12,527,765 10,741,673 Income taxes (1,307,593) (2,265,847) (3,992,578) ----------------- ----------------- ------------------ Results of operations 5,036,311 10,261,918 6,749,095 ================= ================== ================== (c) Capitalized costs 1999 2000 2001 ------------------ ----------------- ------------------ RMB'000 RMB'000 RMB'000 Proved oil and gas properties 33,045,347 36,323,472 40,748,848 Unproved oil and gas properties 711,113 996,452 428,611 Accumulated depreciation, depletion and amortization (13,216,562) (15,482,082) (18,154,653) ------------------ ------------------

----------------- Net capitalized costs 20,539,898 21,837,842 23,022,806 ================== ================= ================== (d) Costs incurred 1999 2000 2001 ----------------- ----------------- ----------------- RMB'000 RMB'000 RMB'000 Acquisition costs - - - Exploration costs 474,210 610,159 996,121 Development costs 3,877,367 4,176,555 3,958,357 ----------------- ----------------- ----------------- Total costs incurred 4,351,577 4,786,714 4,954,478 ================= ================= ================= F-51 SUPPLEMENTARY INFORMATION ON OIL AND GAS PRODUCING ACTIVITIES (UNAUDITED) (CONT'D) (e) Standardized measure of discounted future net cash flows and changes therein In calculating the standardized measure of discounted future net cash flows, year-end constant price and cost assumptions were applied to our estimated annual future production from proven reserves to determine future cash inflows. Year end average realized oil prices used in the estimation of proved reserves and calculation of the standardized measure were US$17 as of December 31, 2001 (2000: US$22; 1999: US$22). Future development costs are estimated based upon constant price assumptions and assume the continuation of existing economic, operating and regulatory conditions. Future income taxes are calculated by applying the year-end statutory rate to estimated future pre-tax cash flows after provision for the tax cost of the oil and natural gas properties based upon existing laws and regulations. The discount was computed by application of a 10% discount factor to the estimated future net cash flows. Management believes that this information does not represent the fair market value of the oil and natural gas reserves or the present value of estimated cash flows since no economic value is attributed to potential reserves, the use of a 10% discount rate is arbitrary, and prices change constantly from year-end levels. Present value of estimated future net cash flows: Note 1999 2000 2001 -------- ---------------- ----------------- ----------------- RMB'000 RMB'000 RMB'000 Future cash inflows (i) 335,668,012 326,513,363 261,339,180 Future production costs (75,159,191) (73,402,341) (74,404,378) Future development costs (ii) (34,712,865) (31,279,348) (38,640,756) Future income taxes (34,632,334) (30,833,803) (39,097,483) ---------------- ----------------- ----------------- Future net cash flows (iii) 191,163,622 190,997,871 109,196,563 10% discount factor (103,441,165) (97,607,274) (58,114,105) ---------------- ----------------- ----------------- Standardized measure 87,722,457 93,390,597 51,082,458 ================= ================= ================= (i) Future cash flows consist of our 100% interest in the independent oil and gas properties and our participating interest in the properties under production sharing contracts less (a) an adjustment for the royalties payable to the PRC government and share oil payable to the PRC government under production sharing contracts and (b) an adjustment for production allocable to foreign partners under the production sharing contracts for exploration costs attributable to the our participating interest. (ii) Future development costs include the estimated costs of drilling future development wells and building the production platforms. (iii) Future net cash flows have been prepared taking into consideration estimated future dismantlement and site restoration costs of dismantling offshore oil platforms and oil and gas properties. F-52 SUPPLEMENTARY INFORMATION ON OIL AND GAS PRODUCING ACTIVITIES (UNAUDITED) (CONT'D) (e) Standardized measure of discounted future net cash flows and changes therein (CONT'D) Changes in the standardized measure of discounted future net cash flows: 1999 2000 2001 ------------------ ----------------- ---------------- RMB'000 RMB'000 RMB'000 Standardized measure, beginning of year: 38,446,846 87,722,457 93,390,597 Sales of production, net of royalties and production costs (8,963,686) (15,658,516) (14,347,890) Net change in prices, net of royalties and production costs 53,656,976 578,121 (32,289,445) Extensions, discoveries and improved recovery, net of related future costs 9,742,935 5,417,977 9,985,707 Change in estimated future development costs (6,512,940) 3,433,517 (9,651,681) Development costs incurred during the year 3,877,367 4,176,555 3,958,357 Revisions in quantity estimates (932,128) 830,236 (3,272,326) Accretion of discount 4,469,855 10,361,478 10,846,714 Net change in income taxes (9,640,963) 815,779 (3,241,861) Sales of property - (2,865,132) - Changes in timing and other 3,578,195 (1,421,875) (4,295,714) ------------------ ----------------- ---------------- Standardized measure, end of year 87,722,457 93,390,597 51,082,458 ================== ================= ================ F-53 EXHIBIT INDEX Exhibit Number Document ------ -------- 1.1 Articles of Association of the Registrant, incorporated by reference to Exhibit 3.1 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 1.2 Memorandum of Association of the Registrant, incorporated by reference to Exhibit 3.2 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.1 The Asset Swap Agreement dated July 20, 1999 between CNOOC and Offshore Oil Company Limited, incorporated by reference to Exhibit 10.1 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.2 The Asset Allocation Agreement dated July 20, 1999 between CNOOC and Offshore Oil Company Limited, incorporated by reference to Exhibit 10.2 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.3 The Reorganisation Agreement dated September 13, 1999 between CNOOC, Offshore Oil Company Limited and CNOOC Limited, incorporated by reference to Exhibit 10.3 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.4 Form of the Equity Transfer Agreement between CNOOC and CNOOC Limited, incorporated by reference to Exhibit 10.4 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.5 Form of the Transfer Agreement dated October 1, 1999 between CNOOC and Offshore Oil Company Limited regarding the transfer of the rights and obligations of CNOOC under the 37 production sharing contracts and one geophysical exploration agreement, incorporated by reference to Exhibit 10.5 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.6 Form of Equity Transfer Agreement between China Offshore Oil East China Sea Corporation and Offshore Oil Company Limited regarding the transfer of the rights and obligations under Joint Venture Contract of Shanghai Petroleum and Natural Gas Company Limited dated July 28, 1992 to Offshore Oil Company Limited, incorporated by reference to Exhibit 10.6 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.7 Transfer Agreement dated September 9, 1999 between CNOOC and Offshore Oil Company Limited regarding the transfer of the rights and obligations of CNOOC under the Natural Gas Sale and Purchase Contract dated December 22, 1992 to Offshore Oil Company Limited, incorporated by reference to Exhibit 10.7 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.8 Transfer Agreement dated September 9, 1999 between CNOOC and Offshore Oil Company Limited regarding the transfer of the rights and obligations of CNOOC under the Natural Gas Sale and Purchase Contract dated November 7, 1992 to Offshore Oil Company Limited, incorporated by reference to Exhibit 10.8 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.9 Transfer Agreement dated September 9, 1999 among CNOOC, Offshore Oil Company Limited, the four PRC subsidiaries and CNOOC's affiliates regarding the transfer of the rights and obligations of the technical services agreements to Offshore Oil Company Limited, incorporated by reference to Exhibit 10.9 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.10 Nanshan Terminal Leasing Agreement dated September 9, 1999 between CNOOC, Hainan China Oil and Offshore Natural Gas Company and Offshore Oil Company Limited, incorporated by reference to Exhibit 10.10 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.11 Trademark Licence Agreement dated September 9, 1999 between CNOOC, Offshore Oil Company Limited and CNOOC Limited, incorporated by reference to Exhibit 10.11 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.12 Trademark Licence Agreement dated September 9, 1999 between China Offshore Oil Marketing Company, CNOOC Limited and Offshore Oil Company Limited and CNOOC Limited, incorporated by reference to Exhibit 10.12 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.13 Agreement for provision of materials, facilities and auxiliary services dated September 9, 1999 between China Offshore Oil Bohai Corporation and Offshore Oil Company Limited, incorporated by reference to Exhibit 10.13 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.14 Agreement for provision of materials, facilities and auxiliary services dated September 9, 1999 between China Offshore Oil Eastern South China Sea Corporation and Offshore Oil Company Limited, incorporated by reference to Exhibit 10.14 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.15 Agreement for provision of materials, facilities and auxiliary services dated September 9, 1999 between China Offshore Oil Western South China Sea Corporation and Offshore Oil Company Limited, incorporated by reference to Exhibit 10.15 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.16 Agreement for provision of materials, facilities and auxiliary services dated September 9, 1999 between China Offshore Oil East South China Sea Corporation and Offshore Oil Company Limited, incorporated by reference to Exhibit 10.16 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.17 General Research and Development Agreement dated September 9, 1999 between China Ocean Oil Research Institute and Offshore Oil Company Limited, incorporated by reference to Exhibit 10.17 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.18 Property Leasing Agreement dated September 9, 1999 between Wui Hai Enterprise Company Limited and Offshore Oil Company Limited in respect of the office premises at 6th, 7th and 8th Floors, CNOOC Plaza, No. 6 Dong Zhi Men Wai Xiao Jie, Beijing, incorporated by reference to Exhibit 10.18 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.19 Property Leasing Agreement dated September 9, 1999 between China Offshore Oil Western South China Sea Corporation and Offshore Oil Company Limited in respect of the office premises at 1st to 9th Floors, Nantiao Road, Potou District Zhangjiang, Guangdong, incorporated by reference to Exhibit 10.19 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.20 Property Leasing Agreement dated September 9, 1999 between China Offshore Oil Bohai Corporation and Offshore Oil Company Limited in respect of the office premises at 1st to 7th Floors and 9th Floor, 2-37 He Kou Jie, Tanggu District, Tianjin, incorporated by reference to Exhibit 10.20 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.21 Property Leasing Agreement dated September 9, 1999 between China Offshore Oil East China Sea Corporation and Offshore Oil Company Limited in respect of the office premises at 20th, 22nd and 23rd Floors, 583 Ling Ling Road, Shanghai, the PRC, incorporated by reference to Exhibit 10.21 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.22 Property Leasing Agreement dated September 9, 1999 between China Offshore Oil Eastern South China Sea Corporation and Offshore Oil Company Limited in respect of the office premises at 3rd Floor and 6th to 11th Floors, 1 Second Industrial Road, Shekou, Shenzhen, the PRC, incorporated by reference to Exhibit 10.22 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.23 Property Leasing Agreement dated September 9, 1999 between China Offshore Oil Bohai Corporation and Offshore Oil Company Limited in respect of the Chengbei Warehouse, Chengbei Road, Tanggu District, Tianjin City, the PRC, incorporated by reference to Exhibit 10.23 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.24 Property Leasing Agreement dated September 9, 1999 between Overseas Oil & Gas Corporation Ltd. and China Offshore Oil (Singapore) International Pte. Ltd. in respect of the residential premises at 10-01 and 17-002 Aquamarine Tower, 50 Bayshore Road, 13-05 Jade Tower, 60 Bayshore Road, Singapore, incorporated by reference to Exhibit 10.24 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.25 Suizhong Pier Agreement dated September 9, 1999 between Offshore Oil Company Limited and China Offshore Bohai Corporation, incorporated by reference to Exhibit 10.25 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.26 Form of Novation Agreement among CNOOC, CNOOC China Limited, the Banks and other financial institution and the Fuji Bank Limited Hong Kong Branch, as agent, in respect of the transfer of the US$110 million syndicated loan, incorporated by reference to Exhibit 10.26 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.27 Form of the Undertaking Agreement between CNOOC and CNOOC Limited, incorporated by reference to Exhibit 10.27 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.28 Employment Contract between CNOOC Limited and Liucheng Wei (Service Agreement for Director, incorporated by reference to Exhibit 10.28 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.29 Employment Contract between CNOOC Limited and Chengyu Fu (Service Agreement for Director, incorporated by reference to Exhibit 10.29 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.30 Employment Contract between CNOOC Limited and Shouwei Zhou (Service Agreement for Director, incorporated by reference to Exhibit 10.30 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.31 Form of Pre-Global Offering Share Option Scheme for the Senior Management of CNOOC Limited, incorporated by reference to Exhibit 10.31 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.32 Form of Share Option Scheme for the Senior Management of CNOOC Limited, incorporated by reference to Exhibit 10.32 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.33 Subscription Agreement dated March 17, 2000 among CNOOC Limited, CNOOC (BVI) Limited, Overseas Oil & Gas Corporation, Ltd., et al., incorporated by reference to Exhibit 10.33 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.34 Subscription Agreement dated May 31, 2000 among CNOOC Limited, CNOOC (BVI) Limited, Overseas Oil & Gas Corporation, Ltd. and Hutchison International Limited, incorporated by reference to Exhibit 10.34 to our Registration

Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.35 Subscription Agreement dated May 31, 2000 among CNOOC Limited, CNOOC (BVI) Limited, Overseas Oil & Gas Corporation, Ltd. and Hongkong Electric Holdings Limited, incorporated by reference to Exhibit 10.35 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.36 Subscription Agreement dated June 28, 2000 among CNOOC Limited, CNOOC (BVI) Limited, Overseas Oil & Gas Corporation, Ltd., et al., incorporated by reference to Exhibit 10.36 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 4.37 Corporation Placing Agreement dated February 6, 2001 among CNOOC Limited, China National Offshore Oil Corporation, Shell Eastern Petroleum (Pte) Limited and Merrill Lynch Far East Limited, incorporated by reference to Exhibit 10.37 to our Registration Statement on Form F-1 filed with the Securities and Exchange Commission (File Number: 333-10862). 8 List of Subsidiaries. 10 Letter from CNOOC Limited dated May 23, 2002 regarding receipt of certain representations from Arthur Andersen & Co. pursuant to the requirements of the United States Securities and Exchange Commission.