

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

SUMMARY

Our operating revenue in 2005 was RMB169,310 million, an increase of 5.0% from 2004. Operating expenses was RMB130,356 million, an increase of 7.4% from 2004; net profit¹ (profit attributable to equity holders of the Company) was RMB27,912 million, and earnings per share were RMB0.34. EBITDA² was RMB88,606 million, and EBITDA margin was 52.3%.

Excluding the amortisation of upfront connection fees of RMB6,781 million, our operating revenue in 2005 was RMB162,529 million, an increase of 6.4% from 2004; net profit¹ (profit attributable to equity holders of the Company) was RMB21,131 million, earnings per share were RMB0.26. EBITDA² was RMB81,825 million and EBITDA margin was 50.3%.

OPERATING REVENUE

Our operating revenue in 2005 was RMB169,310 million, an increase of 5.0% from 2004. Excluding the amortisation of upfront connection fees, our operating revenue in 2005 was RMB162,529 million, an increase of RMB9,775 million or 6.4% from 2004. Revenue from Internet access services and value-added services, and interconnection revenue increased by RMB7,609 million and RMB2,119 million respectively from 2004, which represented the main sources of revenue growth. The growth in local telephone services revenue was stabilising, which increased by 0.8% from 2004. Revenue from leased line services and other businesses increased by 1.4% from 2004. On the other hand, revenue from long distance telephone services and managed data services decreased.

¹ Our net profit for 2004 included a deficit on revaluation of property, plant and equipment of RMB1,262 million.

² Our EBITDA refers to profit before net finance costs, investment income, share of profit from associates, income tax, depreciation and amortisation, deficit on revaluation of property, plant and equipment and minority interests. As the telecommunications business is a capital intensive industry, capital expenditure, the level of gearing and finance costs may have a significant impact on the net profit of companies with similar operating results. Therefore, we believe EBITDA may be helpful in analysing the operating results of a telecommunications service provider like us. Although EBITDA has been widely applied in the global telecommunications industry as a benchmark to reflect the operating performance, financial capability and liquidity, it is not regarded as a measure of operating performance and liquidity under generally accepted accounting principles. It also does not represent net cash from operating activities. In addition, our EBITDA may not be comparable to similar indicators provided by other companies.

The following table sets forth a breakdown of our operating revenue for 2004 and 2005, together with their respective rates of change:

| For the year ended 31 December | | | |
|--|----------------|---------|-------------------|
| | 2005 | 2004 | Rate of Change |
| (RMB in millions, except percentage data) | | | |
| Wireline telephone services ³ | | | |
| Local | | | |
| Installation fees | 2,970 | 2,865 | 3.7% |
| Monthly fees | 30,351 | 29,827 | 1.8% |
| Local usage fees | 47,624 | 47,646 | (0.0)% |
| Subtotal | 80,945 | 80,338 | 0.8% |
| Domestic long distance ⁴ | 25,993 | 26,231 | (0.9)% |
| International, Hong Kong, Macau and Taiwan long distance ⁴ | 3,407 | 3,788 | (10.1)% |
| Interconnections | 12,838 | 10,719 | 19.8% |
| Upfront connection fees | 6,781 | 8,458 | (19.8)% |
| Subtotal | 49,019 | 49,196 | (0.4)% |
| Internet access and value-added services | 27,838 | 20,229 | 37.6% |
| Managed data | 2,958 | 3,015 | (1.9)% |
| Leased line services and others ⁵ | 8,550 | 8,434 | 1.4% |
| Operating revenue (excluding amortisation of upfront connection fees) | 162,529 | 152,754 | 6.4% |
| Total operating revenue | 169,310 | 161,212 | 5.0% |

³ Including revenue from our registered subscribers, public telephones and pre-paid calling cards services.

⁴ Including revenue from VoIP long distance services.

⁵ Including primarily revenue from the lease of telecommunications network facilities and provision of sales and repairs and maintenance of customer-end equipment.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS (continued)

LOCAL TELEPHONE SERVICES

Revenue from our local telephone services grew by 0.8% from RMB80,338 million in 2004 to RMB80,945 million in 2005, which accounted for 47.8% of our operating revenue or 49.8% of our operating revenue excluding amortisation of upfront connection fees. This revenue growth was mainly attributable to the continued growth of our subscriber base. However, as the gap between mobile service tariffs and wireline service tariffs narrowed, mobile operations exacerbated the diversion from wireline services, causing a decrease in local voice ARPU.

Installation fees. Upfront installation fees will be amortised over the expected customer relationship period of 10 years. Revenue from amortisation of upfront installation fees increased by 3.7% from RMB2,865 million in 2004 to RMB2,970 million in 2005.

Monthly fees. Revenue from monthly fees increased by RMB524 million, or 1.8%, from RMB29,827 million in 2004 to RMB30,351 million in 2005.

Local usage fees. Revenue from local usage fees was RMB47,624 million in 2005, which was similar to that of 2004. Local voice usage volume increased by 4.7% from 2004, to 449,404 million pulses in 2005. Due to the intensifying mobile substitution, popularisation of network based communication and the diversification of the means of communication, revenue contribution by traditional voice usage weakened.

LONG DISTANCE TELEPHONE SERVICES

Revenue from our long distance telephone services decreased by 2.1% from RMB30,019 million in 2004 to RMB29,400 million in 2005, representing 17.4% of our operating revenue or 18.1% of our operating revenue excluding amortisation of upfront connection fees.

Domestic long distance services. In 2005, revenue from our domestic long distance services decreased by 0.9% from RMB26,231 million in 2004 to RMB25,993 million in 2005, while domestic long distance telephone usage volume increased by 14.5% from 81,960 million minutes in 2004 to 93,817 million minutes in 2005. The decrease in revenue was attributable to a decrease in average unit price, which decreased from RMB0.32 per minute in 2004 to RMB0.28 per minute in 2005.

International, Hong Kong, Macau and Taiwan long distance services. International, Hong Kong, Macau and Taiwan long distance services revenue decreased by 10.1%, from RMB3,788 million in 2004 to RMB3,407 million in 2005, while the usage volume of our international, Hong Kong, Macau and Taiwan long distance usage volume increased by 3.4% from 2004. The decrease in revenue was attributable to a decrease in average unit price, which decreased from RMB2.29 per minute in 2004 to RMB1.99 per minute in 2005.

INTERNET ACCESS AND VALUE-ADDED SERVICES

Revenue from our Internet access and value-added services increased by 37.6%, from RMB20,229 million in 2004 to RMB27,838 million in 2005, representing 16.4% of our operating revenue or 17.1% of our operating revenue excluding amortisation of upfront connection fees. Driven by the continuous expansion of our broadband subscriber base in recent years, our Internet access services revenue recorded a sustained and rapid growth. The number of our broadband subscribers increased by 7.19 million from the end of 2004 to 21.02 million as of the end of 2005. The increase in the revenue from value-added services was mainly attributable to the rapid development of SMS, caller ID service, Color Ring Tone and telephone information services, of which SMS and Color Ring Tone were the new drivers for revenue growth.

INTERCONNECTION SERVICES

Revenue from our interconnection services increased by 19.8%, from RMB10,719 million in 2004 to RMB12,838 million in 2005, representing 7.6% of our operating revenue or 7.9% of our operating revenue excluding amortisation of upfront connection fees. Increase in such revenue was mainly attributable to an increase in interconnection volume resulting from the expansion of the domestic telecommunications services subscriber base. The increase was also attributable to the revenue from SMS interconnections newly introduced in 2005.

MANAGED DATA SERVICES

Revenue from our managed data services decreased by 1.9%, from RMB3,015 million in 2004 to RMB2,958 million in 2005. The decrease in revenue was mainly attributable to the substitution by new connection methods and therefore reduced the usage volume of conventional services.

LEASED LINE SERVICES AND OTHER BUSINESS

Revenue from our leased line services and other business increased by 1.4%, from RMB8,434 million in 2004 to RMB8,550 million in 2005, representing 5.0% of our operating revenue or 5.3% of our operating revenue excluding amortisation of upfront connection fees.

UPFRONT CONNECTION FEES

Upfront connection fees represent the amortised amount of the upfront fees received for the initial activation of wireline services, amortised over the expected customer relationship period of 10 years. Effective from July 2001, we ceased to charge new subscribers upfront connection fees. The amortised amount decreased by 19.8%, from RMB8,458 million in 2004 to RMB6,781 million in 2005.

The table below sets forth the amortisation of upfront connection fees for each year from 2006 to 2011 based on the calculation of amortisation over the 10-year estimated amortisation period (with 2011 as the end of the amortisation period):

| | For the year ending 31 December | | | | | |
|---|---------------------------------|-------|-------|-------|------|------|
| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
| | (RMB in millions) | | | | | |
| Amortisation of upfront connection fees | 4,965 | 3,295 | 2,022 | 1,151 | 497 | 98 |

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS (continued)**OPERATING EXPENSES**

In 2005, our operating expenses were RMB130,356 million, representing an increase of 7.4% from 2004. The ratio of our operating expenses to operating revenue increased from 75.3% in 2004 to 77.0%, or increased by 0.7 percentage points to 80.2% of our operating revenue excluding amortisation of upfront connection fees. The following table sets out a breakdown of our operating expenses in 2004 and 2005 and their respective rates of change:

| | For the year ended 31 December | | |
|--|--|---------|----------------|
| | 2005 | 2004 | Rate of Change |
| | (RMB in millions, except percentage data) | | |
| Depreciation and amortisation | 49,652 | 47,170 | 5.3% |
| Network operations and support expenses | 30,334 | 27,611 | 9.9% |
| Selling, general and administrative expenses | 19,892 | 19,229 | 3.4% |
| Personnel expenses | 24,960 | 23,233 | 7.4% |
| Interconnection and other operating expenses | 5,518 | 4,139 | 33.3% |
| Total operating expenses | 130,356 | 121,382 | 7.4% |

Depreciation and amortisation

Our depreciation and amortisation expenses were RMB49,652 million in 2005, an increase of 5.3% from 2004, representing 29.3% of our operating revenue. The depreciation and amortisation expenses as a percentage of our operating revenue excluding amortisation of upfront connection fees decreased from 30.9% in 2004 to 30.5% in 2005.

Network operations and support expenses

Our network and support expenses excluding personnel expenses increased by 9.9%, from RMB27,611 million in 2004 to RMB30,334 million in 2005, representing 17.9% of our operating revenue. The network operations and support expenses as a percentage to our operating revenue excluding amortisation of upfront connection fees increased from 18.1% in 2004 to 18.7% in 2005. In order to improve the maintenance quality of our network operations, we appropriately increased our resources input to repairs and maintenance.

Selling, general and administrative expenses

In 2005, selling, general and administration expenses excluding personnel expenses amounted to RMB19,892 million, an increase of 3.4% from RMB19,229 million in 2004, representing 11.7% of our operating revenue. Selling, general and administrative expenses as percentage of our operating revenue excluding amortisation of upfront connection fees decreased from 12.6% in 2004 to 12.2% in 2005. To cope with the market competition, we increased our advertisement and promotion expenses to promote our corporate image, our core and new businesses to bring these in line with our strategic transformation. We also launched advertising and promotion campaigns in tandem with various marketing initiatives (such as service packaging). Therefore, our advertisement expenses increased quickly.

Personnel expenses

In 2005, our personnel expenses increased by 7.4%, from RMB23,233 million in 2004 to RMB24,960 million in 2005, representing 14.7% of our operating revenue, and 15.4% of our operating revenue excluding amortisation of upfront connection fees, an increase of 0.2 percentage points from 2004. This increase was mainly attributable to an increase in reward to employees with good performance in order to maintain and attract professionals and management personnel for our strategic transformation.

Interconnection and other operating expenses

Our interconnection and other expenses increased by RMB1,379 million, from RMB4,139 million in 2004 to RMB5,518 million in 2005, an increase of 33.3%. The significant growth in voice interconnections and the newly added SMS interconnections led to the increase in interconnection fees. The net revenue from interconnections (interconnection revenue less interconnection expenses) amounted to RMB7,365 million, an increase of 11.2% from 2004.

NET FINANCE COSTS

In 2005, our net finance costs were RMB4,895 million, a decrease of RMB445 million or 8.3% from RMB5,340 million in 2004.

Among the components of net finance costs, net exchange gain increased by RMB767 million and interest expenses increased by RMB334 million.

The revaluation of Renminbi in 2005 was the main reason for the net exchange gain. According to the exchange rates published by the People's Bank of China on 30 December 2005, the exchange rates of Renminbi to US dollars, Japanese Yen and Euro increased by 2.5%, 14.7% and 14.9% respectively from 31 December 2004.

We acquired the telecommunications operations in 10 provinces including Hubei on 30 June 2004. The consideration for the acquisition included a deferred payment of RMB15,150 million, and the full year interest expenses thereon in 2005 was the main reason for the increase in interest expenses.

INCOME TAX

Our statutory income tax rate is 33%. In 2005, our income tax expenses were RMB6,160 million, and our effective income tax rate was 18.1%, whereas our effective income tax rate excluding upfront connection fee was 22.5%. The difference between our effective income tax rate and the statutory income tax rate was mainly due to the exclusion of upfront connection fees from taxable revenue, and the preferential income tax rate of 15% enjoyed by our subsidiaries located in special economic zones and in the western part of China. Another reason for our effective tax rate being lower than the statutory tax rate was that some of our operating subsidiaries received tax credits of RMB1,478 million on the purchases of domestic equipment in 2005. As the tax credits on purchases of domestic equipment are subject to various restrictions, we cannot reasonably foresee their impact on the effective tax rate in future years.

NET PROFIT (PROFIT ATTRIBUTABLE TO EQUITY HOLDERS OF THE COMPANY)

In 2005, our operating efficiency and profit level continued to grow steadily and our net profit reached RMB27,912 million. Excluding amortisation of upfront connection fees, our net profit was RMB21,131 million. Our net profit in 2004 was RMB28,023 million, and excluding amortisation of upfront connection fees, it was RMB19,565 million. Excluding amortisation of upfront connection fees, our net profit increased by 8.0% from 2004.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS (continued)**CAPITAL EXPENDITURE**

In 2005, we continued our prudent policy on capital expenditure. Our capital expenditure decreased by 4.3%, from RMB56,307 million in 2004 to RMB53,864 million in 2005. In accordance with our strategic transformation, we further optimised our capital expenditure structure and significantly reduced the capital expenditure on wireless local access service and increased our investment in Internet access and data network. Proportion of the capital expenditure on wireless local access service to the total capital expenditure decreased by 7.1 percentage points, and proportion of the capital expenditure on Internet access and data network to the total capital expenditure increased by 3.1 percentage points from 2004.

In 2006, our estimated capital expenditure is RMB51 billion. The main sources of our capital are cash generated from operating activities, bank borrowings and other indebtedness. We expect that we will have sufficient funding sources to meet our capital expenditure requirements in future.

CASH FLOWS AND CAPITAL RESOURCES**Cash Flows**

In 2005, our net cash inflow was RMB1,656 million, as compared with the net cash inflow of RMB744 million in 2004.

The following table sets out our cash flow position in 2004 and 2005:

| | For the year ended 31 December | |
|---|-----------------------------------|----------|
| | 2005 | 2004 |
| | (RMB in millions) | |
| Net cash flows from operating activities | 68,359 | 66,078 |
| Net cash used in investing activities | (51,894) | (56,353) |
| Net cash used in financing activities | (14,809) | (8,981) |
| Net increase in cash and cash equivalents | 1,656 | 744 |

In 2005, our net cash flow from operating activities was RMB68,359 million, an increase of RMB2,281 million from RMB66,078 million in 2004. Increase in net cash from operating activities indicated the steady growth in our business and an improvement in our operating efficiency.

In 2005, we achieved saving in capital expenditure. Cash used in investing activities was RMB51,894 million, a decrease of RMB4,459 million from 2004.

In 2005, our net cash flows used in financing activities were RMB14,809 million, compared to the net cash used of RMB8,981 million in 2004.

In October 2005, we raised RMB9.88 billion in cash to meet the working capital requirement of our operations through the issue of short-term commercial paper due in six months with a nominal value of RMB10 billion. In addition, we continued to repay certain long-term borrowings in 2005, and net cash used in repaying such borrowings (the difference between the cash from borrowings and the cash used for repaying borrowings) increased from RMB3,950 million in 2004 to RMB9,046 million in 2005.

Working capital

By the end of 2005, our working capital (total current assets minus total current liabilities) deficit was RMB120,313 million, an increase of RMB1,901 million from deficit of RMB118,412 million of 2004. This increase was mainly attributable to an increase in short-term debts, which enjoyed lower interest rates. By the end of 2005, our cash and cash equivalents amounted to RMB15,121 million, of which 99.1% was denominated in Renminbi.

Indebtedness

The indebtedness as of the end of 2004 and 2005 was as follows:

| | As of 31 December | |
|---|-------------------|---------|
| | 2005 | 2004 |
| | (RMB in millions) | |
| Short-term debt | 76,005 | 65,976 |
| Long-term debt maturing within one year | 8,963 | 11,842 |
| Finance lease obligations maturing within one year | 108 | 156 |
| Long-term debt (excluding current portion) | 55,777 | 72,366 |
| Finance lease obligations (excluding current portion) | 52 | 157 |
| Total debt | 140,905 | 150,497 |

By the end of 2005, our total indebtedness was RMB140,905 million, a decrease of RMB9,592 million from 2004. The main reason for the decrease was that we repaid certain long-term borrowings with the net cash generated from our operating activities.

Therefore, the ratio of our total indebtedness to total assets decreased from 36.5% in 2004 to 33.8% in 2005. We believe that the Company has maintained a solid capital structure.

Most of our revenue-generating operations and payments made are denominated in Renminbi, and Renminbi is not a freely convertible currency. By the end of 2005, loans in Renminbi, Japanese Yen, US Dollars and Euro represented 95.6%, 2.0% and 1.7% and 0.6% of our total indebtedness, respectively. 66.4% of our indebtedness was loans with fixed interest rates terms.

CONTRACTUAL OBLIGATIONS

The following table sets out our contractual obligations as of 31 December 2005:

| | Total | Payable in | | | | |
|--------------------------------------|-------------------|---------------|--------------|--------------|------------|---------------|
| | | 2006 | 2007 | 2008 | 2009 | After 2009 |
| | (RMB in millions) | | | | | |
| Short-term debt | 76,005 | 76,005 | – | – | – | – |
| Long-term debt | 64,740 | 8,963 | 8,773 | 3,824 | 382 | 42,798 |
| Finance lease obligations | 160 | 108 | 52 | – | – | – |
| Operating lease commitments | 1,062 | 326 | 195 | 134 | 119 | 288 |
| Capital commitments | 2,791 | 2,791 | – | – | – | – |
| Total contractual obligations | 144,758 | 88,193 | 9,020 | 3,958 | 501 | 43,086 |



A scenic landscape featuring a river in the foreground with a bamboo raft. A large, green fishing net is draped across the middle ground. In the background, there are lush green mountains and dense foliage. The entire image has a green color cast. The text "Going to the Fruitful Future" is overlaid in white.

Going to the Fruitful Future