



CHAIRMAN'S STATEMENT



Wang Xiaochu

Chairman and Chief Executive Officer

Dear Shareholders,

I am very encouraged to see our strategic transformation gaining momentum as reflected in the operating results for the first half of 2006. On executing our strategic transformation, we proactively developed the Internet, value-added and integrated information services. Through effective leverage of multi-services packaging, we have not only abated the serious challenge and the decline in traditional voice services brought by intensifying market competition, but also expanded new revenue sources, leading to continuous growth in our revenue and profit for the first half of the year. More importantly, through our vigorous initiatives on enhancing network's integrated services capabilities, providing innovative services and businesses, expanding integrated information services and cultivating financial strength and talents pool, we have proactively laid a solid foundation for the Company's future comprehensive services convergence offering ("triple-play"). We firmly believe, once the regulatory policies on the Company's comprehensive services operations become clear, we could promptly ride on our unique competitive edge of multi-services convergence offering to achieve business breakthrough and delight our customers, creating value for them and for you as shareholders.



FINANCIAL PERFORMANCE

We achieved solid financial results in the first half of 2006. Our operating revenue reached RMB86,936 million, of which RMB2,494 million was from upfront connection fees. Excluding upfront connection fees, our operating revenue was RMB84,442 million, an increase of 4.7% from the same period of last year. We have optimized revenue structure, with revenue from non-voice services¹ increased to RMB23,244 million in the first half of 2006 from RMB19,046 million in the first half of 2005, accounting for 27.5% of our operating revenue, an increase of 3.9 percentage points against the last corresponding period. EBITDA² was RMB44,217 million, representing a year-on-year increase of 4.0%. EBITDA margin² was 52.4%, staying at a healthy level. Operating expenses was RMB65,704 million, up by 5.5% against the corresponding period last year. The growth in operating expenses was mainly attributable to higher marketing cost for the enhancement of our competitiveness, and therefore selling, general and administrative expenses increased by 14.7% over the same period last year. We had effectively controlled personnel expenses, network operations and support expenses. Profit attributable to equity holders of the Company² reached RMB11,590 million, with net profit margin of 13.7%. Basic earnings per share² was RMB0.143. We reduced capital expenditure to RMB20,773 million, 9.1% less than that in the same period of 2005, capital expenditure on PAS was 66.2% lower than that in the same period of last year. Our free cash flow³ amounted to RMB18,934 million, RMB3,833 million more than that in the first half of 2005.

Taking into consideration the Company's needs for sustainable business development, its cash flow position, and the need to maintain flexibility in funding, the Board of Directors has resolved not to pay any interim dividend for the year. The Board of Directors will proactively review the final dividend proposal at the time of reviewing the full year results and propose to the shareholders' general meeting accordingly.

BUSINESS PERFORMANCE

In the first half of 2006, all subsidiaries performed well in implementing the Company's business development strategy and recorded stable business growth. Signs of success in implementing strategic transformation are emerging.

According to the anticipated decline in the traditional voice services as a result of mobile substitution, we have been proactively transforming the operation model and implementing a strategy which focuses on the profit-oriented development of voice services. Instead of direct price competition and solely pursuing subscriber base expansion to boost revenue growth, we fully utilized the competitive edge of our multi-services operation and strengthened the convergence of voice, Internet and information services. The above initiatives enhanced our non-voice services¹ to become the major revenue growth driver, successfully compensated the declining voice services and thus maintained sustainable revenue growth and consolidated the Company's fundamentals. The total number of access lines in service was 219 million, a net addition of 8.62 million. In the first half of the year, revenue from voice services was RMB61,198 million, similar to that in the same period of last year.

Internet access services and VAS grew rapidly and generated a total revenue of RMB17,734 million, an increase of 35.0% against the same period last year, driving the Company's revenue growth by 5.7%. Broadband access and VAS have become more important in driving the overall revenue growth of the Company. The net addition of broadband subscribers surged to a record high of 4.24 million, bringing the total to 25.26 million. The full deployment of "BizNavigator", an enterprise customer brand, not only satisfied the needs of enterprise informationalization but also facilitated the widespread use of Internet applications, thereby driving the rapid expansion of broadband subscribers. At the same time, broadband ARPU was kept at the same level of the second half of 2005 providing the Company with good effectiveness.

¹ Non-voice services include Internet access services, value-added services, managed data services, leased line services and others.

² Including the amortisation of upfront connection fees, EBITDA was RMB46,711 million, EBITDA margin was 53.7%, profits attributable to equity holders of the Company amounted to RMB14,084 million, and basic earnings per share was RMB0.174.

³ Free cash flow is calculated from EBITDA (excluding the amortisation of upfront connection fees) minus capital expenditure and income tax.



CHAIRMAN'S STATEMENT *(Continued)*

Our VAS demonstrated robust development trend. SMS usage reached 11,166 million messages. Colour Ring Tone subscribers and registered subscribers for "Vnet" were 27.72 million and 15.87 million respectively. Caller ID service has 143 million users, with penetration rate reaching 65.4%. Integrated information services including "Best Tone" and "BizNavigator" were launched with favorable development trend. In about a half-year period, over 0.16 million companies had signed on for "Best Tone" and recorded usage was over 500 million calls, while "BizNavigator" attracted 0.27 million enterprise customers. The Company's new image as an integrated information service provider is taking root in the industries and customers' minds.

In the first half of 2006, we proactively implemented branding strategy on three customer segments, namely enterprises, households and individuals, to progressively build up a customer-centric branding structure. We will continue to enrich the content of "BizNavigator" and establish the brand awareness among customers, closely link telecommunications services to the business of enterprise customers through information applications, with a view to realizing the value enhancement of the Company and our customers simultaneously. We will strengthen the convergence of marketing efforts, terminals and networks of PAS and fixed line telephony to maintain the users' habit of using fixed line telephony. By reinforcing the packaged marketing of broadband, VAS, integrated information service and traditional voice services, we would be able to increase customers "stickiness" and value, and thus lay a solid foundation for the Company's long term sustainable growth.

On the service front, leveraging our existing advantages on direct sales channels, we implemented targeted marketing by identifying different customer segments and sales channels. We also rationalized our sales distribution networks to continuously improve our responsiveness of on-site services and business processing. In addition, we standardized and extended various community channels, such as partnership and agency service. We actively promoted our customer service hotline – "10000", self-served hotline – "10001", and fully deployed our online customer service center. Our core competence of a seamless, three-dimensional, all-rounded sales and marketing channel network is further enhanced.

In addition to tightening control on capital expenditure, we have also been continuously optimizing our capital expenditure structure. Aiming to give customers improved services and reinforce our competitive edges, we accelerated the upgrading of our intelligent fixed line network and optimized the IP-based Metropolitan Area Network (MAN), access network and wireless local access network. Meanwhile, we increased our investment in broadband and VAS and speeded up the development of our IT systems such as Business Supporting Systems (BSS). Such initiatives could strengthen the overall capability of our network and IT systems for supporting the provision of integrated information services, and make ourselves well-prepared for providing comprehensive services in the future.

Through the innovative human resources mechanism on recruitment, training and usage, we proactively optimize the allocation of human resources and cultivate talents in management, technology, sales and maintenance for providing comprehensive services in the future. The Company is determined to consolidate its human resources advantages in the long run.

CORPORATE GOVERNANCE

Improving corporate governance and the transparency of our operations commands our continuous effort. This year, we began to disclose monthly subscriber data and further enriched the quarterly disclosure of key business and financial indicators to allow investors to gain more timely and thorough understanding of our operations. The Company continued to hold its annual general meeting in Hong Kong and fully utilized its website for a more effective communication with shareholders. Following international best practices and regulatory requirements like Sarbanes-Oxley Act of 2002 (Section 404), and basing on the continuously improved internal control system in the past three years, we undertook measures such as authority limits setting and grade assessment to strengthen our internal control responsibility system, perfect corporate governance, reduce corporate risks and enhance operational efficiency.



FUTURE PROSPECTS

In the past year or so, we have gained precious experience and achieved encouraging results in our strategic transformation. Our new core competitive strengths are promptly developed and information services including “Best Tone” and “BizNavigator” are posing bright prospects. We strongly believe that information services will bring a vast potential in value creation to the Company in the near future and further enhance our ability to create sustainable value to shareholders.

We will continue to advance our strategic transformation. We will follow diligently our pre-set strategies to consolidate the fundamentals of our voice services, elaborate our edges of multi-services, strengthen the convergence of businesses and terminals, persist in product packaging, improve effective differentiation in our products and services, with a view to enhancing value for our customers. The Company will increase effort to raise customer awareness of the branding on “BizNavigator” and gradually launch new individual and household service brands to boost the competitiveness of our branding. We will lead and satisfy customers’ communications and information application needs and work towards elevating our position on the value chain to establish our leadership position in the integrated information service sector.

Looking ahead, we believe that the successful implementation of strategic transformation will significantly enhance our core competitive capabilities. Through transforming the enterprise value growth model, further enhancing precision management, optimizing resources allocation, strengthening the cost and investment controls, we are committed to improve our profitability and maximize shareholders’ value.

Finally, on behalf of the Board of Directors, I would like to express my gratitude to our shareholders and customers for their support over the years. I would also like to thank Mr. Wei Leping for his outstanding contribution to the Company as Executive Director. Last but not least, I would like to express my heartfelt appreciation to our employees for their hard work and especially their willingness to take on the challenges and pressure in the Company’s business transformation process.

Wang Xiaochu

Chairman and Chief Executive Officer

Beijing, PRC
30 August 2006