

# EFFICIENCY





In preparation for the listing of the Company on the Hong Kong Stock Exchange and the New York Stock Exchange, the Company underwent a restructuring, pursuant to which the Company transferred the assets and liabilities of China Netcom (Group) Company Limited, a wholly-owned subsidiary of the Company, to China Netcom Group, the ultimate controlling shareholder of the Company. China Netcom Group then transferred the assets and liabilities related to the fixed-line telecommunication operations in our relevant service regions to the Company, and retained certain assets and liabilities previously owned by the Company (hereinafter referred to as the "Group's retained assets and liabilities"). The Company also transferred certain undersea cable assets of the Asian Pacific region and the related assets and liabilities to China Netcom Group.

As the restructuring was effective on June 30, 2004, the figures for 2003 and the first half of 2004 included the operational and financial data of the Company and the Group's retained assets and liabilities, whereas the figures for the second half of 2004 only included the operational and financial data of the Company. The following discussion and analysis shall be read with the Financial Statements and the notes thereof as set out on pages 88 to 156 of this annual report.

The Company recorded favourable revenue growth to RMB64,922 million in 2004, representing an increase of 8.4% over 2003. Our operating expenses were effectively under control. Our operating expenses were RMB49,486 million in 2004, representing a growth of 1.5% over 2003 which was considerably slower than the growth in revenue. EBITDA<sup>(1)</sup> was RMB34,190 million, representing a EBITDA margin of 52.7%. Operating profit<sup>(2)</sup> jumped to RMB15,436 million, growing by 38.3% over 2003. We recorded a net profit of RMB9,248 million, representing a growth of RMB20,359 million against 2003. The size of capital expenditure was effectively controlled at RMB21,239 million. We have sufficient cash flow for the operating activities. The basic earnings per share was RMB1.64.

- (1) EBITDA refers to profit before finance costs, interests income, dividend income, income tax, depreciation and amortization, share of loss of associated companies and jointly controlled entity, and minority interests. To supplement our consolidated financial statements presented in accordance with the Hong Kong GAAP, we use the non-Hong Kong GAAP measure of EBITDA, which is adjusted from our results based on Hong Kong GAAP. We believe that EBITDA provides useful information to both management and investors to further analyse our operating results since we, as a company operating in the capital intensive telecommunication industry, incurred significant capital expenditure and finance costs which have significant impact to our results based on Hong Kong GAAP. EBITDA should only be considered in addition to our Hong Kong GAAP results. It should not be considered a substitute for or superior to our Hong Kong GAAP results as it cannot be used to measure operating results and liquidity and does not represent operating cash flows. In addition, our EBITDA may not be comparable to similar indicators of other companies.
- (2) Operating profit before interest income, dividend income and deficit on revaluation of fixed assets.

The following sets out the operating revenue, operating expenses, operating profit and net profits of the Company (based on amount and percentage of total revenue).

	Years Ended 31 December			
	2003		2004	
	Amount	Percentage of revenue	Amount	Percentage of revenue
	(RMB in millions, except percentage data)			
Operating revenue	59,898	100.0%	<b>64,922</b>	<b>100.0%</b>
Operating expenses	48,733	81.4	<b>49,486</b>	<b>76.2</b>
Operating profit	11,165	18.6	<b>15,436</b>	<b>23.8</b>
Net profit	-11,111	—	<b>9,248</b>	<b>14.2</b>



## Revenue

Sources of our revenue consist of revenue from fixed-line telephone services, broadband and other Internet-related services, business and data communications services and international telecommunications services.

Our revenue were RMB64,922 million in 2004, representing a growth of RMB5,024 million or 8.4% over RMB59,898 million in 2003. This growth primarily reflected increases in local telephone, broadband and other internet-related services, value-added services, domestic interconnection fees and international telecommunications services.

The following table illustrates a breakdown of our revenue and their percentage of our total revenue in 2003 and 2004.

	Years Ended 31 December			
	2003		2004	
	Amount	Percentage of revenue	Amount	Percentage of revenue
	(RMB in millions, except percentage data)			
Domestic Telecommunication Services:				
Fixed-line telephone <sup>(1)</sup> :				
Local:				
Local usage fees	18,567	31.0%	<b>18,661</b>	<b>28.7%</b>
Monthly fees	12,580	21.0	<b>13,743</b>	<b>21.2</b>
Upfront installation fees	1,044	1.7	<b>1,338</b>	<b>2.1</b>
Subtotal	32,191	53.7	<b>33,742</b>	<b>52.0</b>
Domestic long distance <sup>(2)</sup>	8,871	14.8	<b>8,813</b>	<b>13.6</b>
International long distance <sup>(2)(3)</sup>	1,410	2.4	<b>1,121</b>	<b>1.7</b>
Value-added services	1,516	2.6	<b>2,146</b>	<b>3.3</b>
Interconnection fees from domestic carriers	2,580	4.3	<b>3,903</b>	<b>6.0</b>
Upfront connection fees <sup>(4)</sup>	3,965	6.6	<b>3,378</b>	<b>5.2</b>
Subtotal	50,533	84.4	<b>53,103</b>	<b>81.8</b>

# Management's Discussion and Analysis of Financial Condition and Results of Operations

	Years Ended 31 December			
	2003		2004	
	Amount	Percentage of revenue	Amount	Percentage of revenue
	(RMB in millions, except percentage data)			
Broadband and other				
Internet-related services	3,493	5.8	5,058	7.8
Business and data communications services:				
Managed data	1,215	2.0	1,217	1.9
Leased line	2,446	4.1	1,825	2.8
Subtotal	3,661	6.1	3,042	4.7
Other services	832	1.4	1,076	1.7
Subtotal	58,519	97.7	62,279	95.9
International				
Telecommunications Services:				
International long distance	—	—	181	0.3
Interconnection fees from international carriers	1,217	2.0	1,012	1.6
Broadband and other				
Internet-related services	14	0.0	360	0.6
Managed data	64	0.1	309	0.5
Leased Lines	63	0.1	496	0.8
Other services	21	0.0	285	0.4
Subtotal	1,379	2.3	2,643	4.1
Total	59,898	100.0	64,922	100.0

- (1) Includes revenue from our PHS services.
- (2) Includes revenue from our IP voice long distance services.
- (3) Includes revenue from long distance calls to Hong Kong, Macau and Taiwan.
- (4) In July 2001, the upfront connection fees charged on basic telephone access services were eliminated by the MII.



## Domestic telecommunications services

### Fixed-line telephone services

*Local telephone services.* Revenue from our local telephone services (including PHS services) comprise local usage fees, monthly fees and upfront installation fees.

Revenue from our local telephone services were RMB33,742 million in 2004, representing an increase of RMB1,551 million, or 4.8%, from RMB32,191 million in 2003, accounting for 52.0% of our total revenue in 2004. Local telephone services were still our main services. The growth in revenue from local telephone services benefited from the expansion of subscriber base. In 2004, the Company's subscribers of fixed-line telephone amounted to 80.38 million, representing an increase of 10.77 million or 15.5% over 69.61 million in 2003.

*Local usage fees.* Usage fees for local services include local usage fees charged for local telephone calls and VOIP long distance calls, and usage fees for dial-up Internet access.

Revenue from our local telephone services were RMB18,661 million in 2004, representing an increase of RMB94 million, or 0.5%, from 18,567 million in 2003. The growth was mainly attributable to usage volume of local calls (excluding usage of dial-up Internet services), which was 161.5 billion pulses in 2004, representing an increase of 8.1 billion pulses, or 5.3%, from 153.4 billion pulses in 2003. The usage volume of our dial-up Internet access fell by 44.8%, reflecting the migration of Internet dial-up traffic to broadband services.

*Monthly fees.* Monthly fees represent the fixed amount of service charges to our customers for using our fixed-line telephone services.

In 2004, our revenue from monthly fees were RMB13,743 million, representing an increase of RMB1,163 million, or 9.2%, from RMB12,580 million in 2003. The revenue growth was largely attributable to the increase in the number of our fixed-line subscribers.

*Upfront installation fees.* Installation fees represent the amortised amount of the upfront fees received for installation of fixed-line telephone services. These upfront installation fees are amortised over the expected customer relationship period, which is currently estimated to be ten years.

Revenue from the amortised amount of installation fees were RMB1,338 million in 2004, representing an increase of RMB294 million, or 28.2%, from RMB1,044 million in 2003. This increase principally reflects an increasing number of subscribers for the Company.

*Long distance services.* Revenue from our long distance services consist of usage fees for domestic long distance calls and international long distance calls.

Our revenue from our long distance calls were RMB9,934 million in 2004, representing a drop of RMB347 million, or 3.4%, from RMB10,281 million in 2003. The usage volume of long distance calls was 24.2 billion minutes in 2004, representing an increase of 1.4 billion minutes, or 6.3%, from 22.8 billion minutes in 2003. The decrease in revenue was resulted from a decrease in our realized tariff because of the increase in the proportion of long distance calls carried on our VOIP network.

*Value-added services.* Revenue from our value-added services consist of fees that we charge our customers for the provision of caller identification, PHS short messages, telephone information services, video- and tele-conferencing and other value-added services.

Revenue from our value-added services were RMB2,146 million in 2004, representing an increase of RMB630 million, or 41.6%, from RMB1,516 million in 2003. The increase was primarily due to the growth in the number of subscribers of our caller identification service, and increased usage of telephone information services, PHS short messages and other value-added services. As at 31 December 2004, the penetration rate of caller identification services reached 58.2% of our access lines in services.

*Interconnection services.* Revenue from our interconnection services represent interconnection fees charged to other domestic telecommunications carriers and associates for interconnection of both local and long distance calls.

Revenue from our interconnection services with domestic carriers was RMB3,903 million in 2004, representing an increase of RMB1,323 million or 51.3%, from RMB2,580 million in 2003. The increase was primarily due to increases in the interconnection fees from other domestic carriers, and the Company began to settle interconnection fees with China Telecom and our associated companies in 2004.

*Upfront connection fees.* Upfront connection fees represent the amortised amount of the upfront fees received for the initial activation of fixed-line telephone services.

Revenue from our upfront connection fees was RMB3,378 million in 2004, decreased by RMB587 million, or 14.8%, from RMB3,965 million in 2003, and will continue to decline in the coming years until they are amortised completely.



## Broadband and other Internet-related services

Revenue from our broadband and other Internet-related services consist of revenue from the provision of DSL, LAN and other broadband services, as well as Internet dial-up (other than communication fees) and dedicated Internet access services.

Revenue from our broadband and other Internet-related services were RMB5,058 million in 2004, representing an increase of RMB1,565 million, or 44.8% from RMB3,493 million in 2003. The proportion of revenue from our broadband and other Internet-related services in our total revenue rose to 7.8% against 5.8% in 2003, and became one of our main sources of revenue. These increases were primarily due to remarkable growth in service revenue from our broadband services, reflecting the rapid expansion of our broadband subscriber base. The total number of our broadband subscribers was 6.22 million in 2004, up 3.63 million, or 139.8%, from 2.59 million in 2003.

## Business and data communications services

*Managed data services.* Revenue from our managed data services represent fees that we charge for DDN, frame relay, ATM, MPLS VPN and X.25 services.

Revenue from our managed data services were RMB1,217 million in 2004, representing a growth of RMB2 million, or 0.2%, from RMB1,215 million in 2003, primarily due to growth in the total leased bandwidth of our frame relay service, ATM services and MPLS VPN services. These increases resulted from the increase in the demand for managed data services from the business customers in our domestic service regions.

*Leased line services.* Revenue from our leased line services represent fees that we receive from our business and carrier customers for leasing circuit capacity to them, including the lease of digital circuits, digital trunk lines and optic fibers.

Revenue from our leased line service were RMB1,825 million in 2004, representing a decrease of RMB621 million, or 25.4% from RMB2,446 million in 2003. This decrease was primarily caused by switching from our network to these carriers' own networks and a decline in lease of bandwidth. Another reason for the decrease was the shift in leased line subscribers to higher bandwidth, resulting in a lower average tariffs.

*Other services.* Revenue from other services, including revenue from service and maintenance fees, lease payments for our non-telecommunications equipment, paging service fees, and revenue from sales of products such as handsets and DSL modems.

Operating revenue from other communications services were RMB1,076 million in 2004, representing an increase of 244 million, or 29.3%, from RMB832 million in 2003.



## International telecommunications services

Revenue from our international telecommunications services consist of fees charged for provision to carrier customers of wholesale voice services, and leased line, Internet, managed data and other telecommunications services provided to business and carrier customers located outside the PRC.

Revenue from our international telecommunications services were RMB2,643 million in 2004, representing an increase of RMB1,264 million, or 91.7%, from RMB1,379 million in 2003. (Revenue generated from Asia Netcom, which amounted to RMB1,040 million, were not reflected in our revenue data in 2003, as we used equity accounting for Asia Netcom during 2003.) The increases were primarily due to increases in revenue from our broadband and other Internet-related services, managed data services and leased line services.

## Operating expenses

The key components of our operating expenses are depreciation and amortisation expenses, network, operations and support expenses, selling, general and administrative expenses, staff costs and other operating expenses. Our total operating expenses were RMB49,486 million in 2004, representing an increase of RMB753 million, or 1.5%, from RMB48,733 million in 2003. However, the growth rate was lower than that of revenue. The increase in operating expenses was due to the consolidation of Asia Netcom and inclusion of its operating expenses into the Group's total expenses from January 1, 2004 as it became a 100% owned subsidiary on December 31, 2003. Prior to that date, we accounted for the results of Asia Netcom under equity accounting method.

	Years Ended 31 December			
	2003		2004	
	Amount	Percentage of revenue	Amount	Percentage of revenue
	(RMB in millions, except percentage data)			
Depreciation and amortisation	20,483	34.2%	<b>18,754</b>	<b>28.9%</b>
Network, operations and support	11,990	20.0	<b>11,591</b>	<b>17.9</b>
Selling, general and administrative	7,053	11.8	<b>9,566</b>	<b>14.7</b>
Staff costs	7,547	12.6	<b>8,041</b>	<b>12.3</b>
Other operating expenses	1,660	2.8	<b>1,534</b>	<b>2.4</b>
<b>Total operating expenses</b>	<b>48,733</b>	<b>81.4</b>	<b>49,486</b>	<b>76.2</b>



## Depreciation and amortisation

We depreciated our property, plant and equipment on a straight-line basis over the estimated useful lives of the assets, after taking into account their estimated residual value. In 2004, our depreciation and amortisation expenses were RMB18,754 million, representing a reduction of RMB1,729 million, or 8.4%, from RMB20,483 million in 2003. The decrease was primarily attributable to the revaluation deficit of our fixed assets in 2003. Another important factor was that at the same time, we were making effort to reduce our capital expenditures in 2004.

## Network, operations and support

Network, operations and support expenses primarily consist of repair and maintenance expenses incurred in connection with the operation of our telecommunications networks, interconnection expenses, utility expenses, and the installation costs for additional access lines that are put in service each year. In 2004, these expenses amounted to RMB11,591 million, representing a decrease of RMB399 million, or 3.3%, from RMB11,990 million in 2003, which was primarily attributable to our reform on the conventional network operation model, enhancement of management in components and parts and apparatus and instruments, proactive exploration on efficiency improvement, and centralised management of resources, thereby reducing the repair and maintenance expenses by 21.6%.

## Selling, general and administrative

Selling, general and administrative expenses primarily consist of sales and marketing expenses, general and administrative expenses.

In 2004, our selling, general and administrative expenses were RMB9,566 million, representing an increase of RMB2,513 million, or 35.6%, from RMB7,053 million in 2003. The growth in these expenses was primarily attributable to the continued expansion in the number of subscribers, intensified market competitions, resulting in the increase in market promotion expenses. However, our administrative and management expenses such as office expenses and travelling expenses reduced, reflecting the effect of cost reduction and improvement in efficiency.

### Staff costs

Staff costs principally consist of expenses for salary and benefits, contributions to pension plans and others.

In 2004, our staff costs were RMB8,041 million, representing an increase of RMB494 million, or 6.5%, from RMB7,547 million in 2003, which was primarily attributable to the adoption of the state medical scheme by more branches during the year. Of these expenses in 2004, wages and salaries amounted to RMB5,013 million, representing a decrease of RMB78 million, or 1.5%, from RMB5,091 million in 2003, which was primarily attributable to the reduction of certain temporary workers through our staff restructuring.

### Other operating expenses

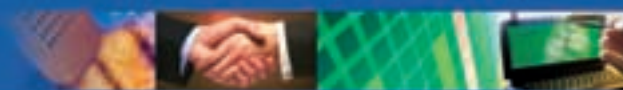
In 2004, our other operating expenses were RMB1,534 million, representing a decrease of 7.6% from RMB1,660 million in 2003.

### Operating profit before interest income, dividend income and deficit on revaluation of fixed assets

In 2004, our operating profit before interest income, dividend income and deficit on revaluation of fixed assets was RMB15,436 million, representing an increase of RMB4,271 million, or 38.3%, from RMB11,165 million in 2003, which was primarily attributable to the higher growth in our revenue by 6.9% over the growth of the total operating expenses.

### Profit/(loss) from operations

In 2004, our profit derived from operations was RMB15,529 million, representing an increase of RMB30,018 million from a loss of RMB14,489 million in 2003. This increase was primarily attributable to that we incurred a loss from the deficit on revaluation of our fixed assets of RMB25,778 million in 2003. On the other hand, we actively expanded the markets, and the number of subscribers continued to surge, while at the same time dedicated to cost reduction to enhance efficiency, thus realised a lower increase in the total operating expenses, and enhanced the profit level accordingly.



## Finance costs

In 2004, our finance costs were RMB2,932 million, representing a decrease of RMB94 million, or 3.1%, from RMB3,026 million in 2003, which was primarily attributable to the reduction in our total borrowings.

## Share of profit/(loss) of a jointly controlled entity

Our share of profit/(loss) in Asia Netcom, a jointly controlled entity, was consolidated into our operating profits in 2004.

## Taxation

In 2004, our taxation expense was RMB3,348 million, with an effective tax rate of 26.6%. Our effective tax rate was different from the State statutory tax rate, which was mainly because the revenue from upfront connection fee that we recognized during these periods were exempted from taxation under the PRC law.

## Profit/(loss) for the year

As a result of the foregoing, our profit for 2004 was RMB9,248 million, representing an increase of RMB20,359 million over 2003.

## Profit/(loss) for the year reconciled to U.S. GAAP

Our consolidated profit as determined pursuant to U.S. GAAP for 2004 was RMB6,896 million. Our profit for 2004 determined in accordance with U.S. GAAP was lower than our results determined in accordance with Hong Kong GAAP, principally due to the deficit of RMB25,778 million to the carrying value of our fixed assets based on the results of assets appraisal in 2003 calculated under Hong Kong GAAP, resulting in the lower depreciation charges recorded under Hong Kong GAAP than those calculated under U.S. GAAP. In future years, we expect that this will be one of the principal differences between two GAAPs.

## Capital expenditures

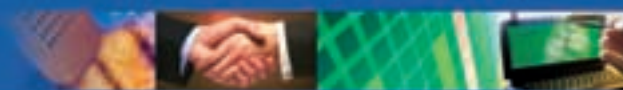
The following table sets forth our actual and planned total capital expenditure requirements for the periods indicated:

	(RMB in millions)
2002	25,814
2003	28,528
2004	21,239
2005 (Planned)	21,400
2006 (Planned)	21,400

In 2004, our capital expenditures were RMB21,239 million, representing a significant decline over 2003, which was primarily attributable to our focus in improving the utilization rate of our existing network equipment, implementation of capital expenditure policy focusing on efficiency, appropriate utilization of credit provided by the suppliers and reasonably containing capital expenditures. Our capital investments in 2004 mainly included: continue to improve and expand our data network, providing support to our broadband service; capital investments to our switching and transmission network; selectively conducting capital investments, in order to further expand our local access network in our northern and southern service regions, and to further promote PHS service in the high communication consumption areas in our northern service regions.

We expect that our capital expenditures are subject to uncertainty, and actual capital expenditures in future may differ significantly from these plannings. Many factors could cause changes to the timing, amounts and nature of our capital expenditures, including overall economic environment, customer demand, utilization rate of our network resources, technological advances, and other relevant factors.

We anticipate that we will have to utilize cash derived from operating activities, short and long term bank loans, net proceeds from the initial global offering and other borrowings and equity financing to satisfy our needs of capital expenditures. We think that we will have sufficient capital resources to satisfy our capital expenditure requirements in the foreseeable future periods.



## Liquidity and capital resources

### Liquidity

Our net cash inflow in 2004 was RMB3,750 million, representing a net increase of RMB4,157 million comparing with net cash outflow of RMB407 million in 2003. In 2004, we derived substantial amount of cash from the initial global offering, and net cash inflow from the operating activities maintained a steady growth, with capital expenditures substantially reduced, thereby enabling cash and cash equivalents to increase substantially.

The following table summarizes our net cash flows for the periods indicated:

	For the Years Ended 31 December	
	2003	2004
	(RMB in millions)	
Net cash inflow from operating activities	25,332	<b>26,870</b>
Net cash outflow from investing activities	(27,001)	<b>(21,707)</b>
Net cash inflow/(outflow) from financing activities	1,262	<b>(1,413)</b>
Increase/(decrease) in cash and cash equivalents	(407)	<b>3,750</b>

### Net cash inflow from operating activities

Our net cash inflow from operating activities in 2004 was RMB26,870 million, representing an increase of RMB1,538 million, or 6.1% comparing with RMB25,332 million in 2003. The increase was primarily attributable to the increase in the cash inflow from our operating activities and decrease in the profit taxes paid.

### Net cash outflow for investing activities

Our net cash outflow for investing activities in 2004 was RMB21,707 million, representing a decrease of RMB5,294 million, or 19.6%, comparing with RMB27,001 million in 2003, over 97% of which was used to purchase fixed assets and fund construction in progress. The substantial reduction in the net cash outflow for investing activities in 2004 over 2003 was primarily attributable to our control on the capital expenditures.

### Net cash inflow/(outflow) from financing activities

Our net cash outflow from financing activities in 2004 was RMB1,413 million, representing a change of RMB2,675 million comparing with inflow of RMB1,262 million in 2003, which was primarily attributable to the repayment of the short-term borrowings and the increase of the payment of profit distributions to the parent company.

### Working capital

Our working capital (current assets less current liabilities) as at 31 December 2004 was a shortage of RMB51,367 million, representing a decrease of RMB18,012 million, or 26.0%, from the shortage of RMB69,379 million in the working capital as at 31 December 2003, which was primarily attributable to the net proceeds of RMB8,944 million from our IPO in 2004 and the net reduction of short term debt by RMB11,324 million.

The following table sets forth our liabilities as at the dates indicated:

	As at 31 December	
	2003	2004
	(RMB in millions)	
Short-term debt	32,217	29,339
Current portion of long-term debt	15,716	7,270
Long-term debt net of short-term portion	22,309	21,861
Total debt	70,242	58,470





### Market risk and risk management

Market risk is the risk of loss related to adverse changes in market prices, including interest rates and foreign exchange rates, of financial instruments we hold or have issued, all of which were for purposes other than trading purposes. In the normal course of business, we are routinely subject to a variety of risks, including market risk associated with interest rate movements and exchange rate movements on non-Renminbi denominated assets and liabilities.

### Foreign exchange rate risk

We conduct our business primarily in Renminbi, which is also our accounting and reporting currency. The Renminbi is not a fully convertible currency. Although the Renminbi to United States dollar exchange rate has been relatively stable since 1994, fluctuations in exchange rates may adversely affect the value, translated or converted into United States dollars or Hong Kong dollars (which are pegged to the U.S. dollar), of our net assets, earnings and any declared dividends.

We are exposed to foreign currency risk primarily as a result of our foreign currency borrowings for past purchases of telecommunications equipment from overseas suppliers. In addition, we receive some of our revenue from our international telecommunications services and pay related expenses in foreign currencies. As a result, our foreign currency exposure relates to our foreign currency-denominated debt and, to a limited extent, cash and cash equivalents denominated in foreign currencies.

We have, in the past, entered into currency swap agreements and foreign exchange forward contracts designed to mitigate our exposure to foreign currency risks and may continue to do so in the future. Please refer to note 24 to the financial statements on forward currency exchange contracts for details.



## Interest rate risk

The People's Bank of China has the sole authority in China to establish the official interest rates for Renminbi-denominated loans. Financial institutions in China set their effective interest rates within the range established by the People's Bank of China. Interest rates and payment methods on loans denominated in foreign currencies are set by financial institutions based on interest rate changes in the international financial market, cost of funds, risk levels and other factors.

We are subject to market risks due to fluctuations in interest rates on our debt. The majority of our debt is in the form of bank loans from banks in China. Increases in interest rates will increase the cost of new borrowing and the interest expense with respect to outstanding floating rate debt. Accordingly, fluctuations in interest rates can lead to significant fluctuations in the fair value of these debt instruments.

All the short term bank loans as at 31 December, 2004 were unsecured. Among the long-term bank loans, as at 31 December, 2004, secured loans amounted to RMB2,343 million. Please refer to note 27 to the financial statements on bank and other loans for details.