

Report of the Directors

The directors are pleased to present their annual report together with the audited financial statements for the year ended 31 December 2005.

Principal activities

The Group is a dominant provider of fixed-line telephone services, broadband, other internet-related services, and business and data communications services in ten northern municipalities and provinces in China, namely Beijing Municipality, Tianjin Municipality, Hebei Province, Henan Province, Shandong Province, Liaoning Province, Heilongjiang Province, Jilin Province, Neimenggu Autonomous Region and Shanxi Province. The Group also provides telecommunications services to selected business and residential customers in two southern municipality and province, namely Shanghai Municipality and Guangdong Province in China. The Group operates an extensive network and offers international data services in the Asia Pacific region. The principal activity of the Company is investment holding.

The turnover of the Group during the financial year consisted primarily of income generated from the provision of fixed-line telecommunications and related services.

Major customers and suppliers

The Group's aggregate sales attributable to its five largest customers did not exceed 30 per cent. of the Group's total sales in 2005.

The Group's aggregate purchases from its five largest suppliers did not exceed 30 per cent. of the Group's total purchases in 2005.

Subsidiaries

Particulars of the Company's subsidiaries as at 31 December 2005 are set out in note 26 to the financial statements.

Financial statements

The results of the Group for the year ended 31 December 2005 and the Company's and the Group's financial positions as at that date are set out in the financial statements on pages 80 to 158.

Dividends

The Company has always held in the highest regard the interests of and returns achieved for its shareholders. Having taken into account such factors as our results of operations, cash flows, financial condition, future prospects, and statutory and regulatory restrictions on the payment of dividend by the Company, the Board recommends payment of a final dividend of HK\$0.466 per share and a total dividend of HK\$3,073 million for the financial year ended 31 December 2005. In 2005, the Company has made an acquisition which was completed on 31 October 2005. The Company's net profits for the year ended 31 December 2005 available for distribution were in the total sum of HK\$8,782 million, consisting of the net profit of the Company (without taking into account the assets acquired) for the full year of 2005 and the net profit attributable to China Netcom Group New Horizon Communications Corporation Limited (being the assets acquired) from 31 October 2005 (being the completion date of the acquisition) to 31 December 2005 (excluding upfront connection fees). The dividend payout ratio for 2005, based on the said net profit of HK\$8,782 million is 35%. If the relevant resolution relating to declaration of dividend is passed, the dividend will be distributed on or about 6 June 2006 to shareholders whose names are registered on the Company's shareholders' register on 16 May 2006.



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Charitable donations

Donations made by the Group during the year amounted to RMB0.8 million (2004: RMB24 million).

Fixed assets

Changes of the fixed assets of the Group and the Company during the year are set out in note 21 to the financial statements.

Bank and other loans

Particulars of bank and other loans of the Group as at 31 December 2005 are set out in note 29 to the financial statements.

Share capital and share option scheme

Details of the Company's share capital and share option scheme are set out in note 34 and note 35, respectively, to the financial statements. Information on the share option scheme can also be found in the paragraphs "Share option scheme" and "Supplementary Information for American Depositary Shares Holders" below.

Purchase, sale or redemption of the Company's listed securities

During the year, neither the Company nor any of its subsidiaries purchased, sold or redeemed any of the Company's listed securities.

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Reserves

Changes to the reserves of the Company and the Group during the year are set out in note 36 to the financial statements, and consolidated statement of changes in equity, respectively.

Financial summary

A summary of the audited results and of the audited assets and liabilities of the Group for the last four financial years is set out on pages 167 to 168.

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Connected Transactions

(1) (a) The Acquisition

The Company, China Netcom Group Corporation (BVI) Limited ("**CNC BVI**"), the direct controlling shareholder of the Company and China Network Communications Group Corporation ("**China Netcom Group**"), the ultimate controlling shareholder of the Company, entered into a conditional sale and purchase agreement (the "**Acquisition Agreement**") on 12 September 2005, pursuant to which the Company agreed to acquire the entire equity interests of China Netcom Group New Horizon Communications Corporation (BVI) Limited (the "**Target Company**") from CNC BVI (the "**Acquisition**"). The Target Company holds the business operations and assets in telecommunications of China Netcom Group in Heilongjiang Province, Jilin Province, Neimenggu Autonomous Region and Shanxi Province through China Netcom Group New Horizon Communications Corporation Limited ("**New Horizon Communications**"). The purchase price of the Acquisition was RMB12,800 million, the initial consideration of RMB3,000 million was satisfied on completion of the Acquisition, and the payment of the balance in the amount of RMB9,800 million is deferred. From the date of completion of the Acquisition, the deferred consideration and interest on the actual amount of the deferred consideration remaining outstanding will be repaid at half-yearly intervals, and the interest rate is 5.265% per annum. The repayment of deferred consideration at each half-yearly interval will be in equal amount of RMB980 million. The Acquisition was announced by the Company on 12 September 2005, and the details was contained in a circular which was despatched to the shareholders of the Company on 23 September 2005. The Acquisition was completed on 31 October 2005.

(b) Cooperation Agreement in relation to the 2008 Beijing Olympic Games

On 15 September 2005, the Company's wholly-owned subsidiary, CNC Netcom (Group) Company Limited ("**CNC China**") entered into a cooperation agreement (the "**Cooperation Agreement**") with China Netcom Group whereby CNC China agreed to provide telecommunications goods and services to the Beijing Organization Committee for the Games of the XXIX Olympiad ("**BOCOG**"). As consideration, CNC China is entitled to the right and opportunity to conduct products-related marketing activities by using the 2008 Olympics composite logo and sponsorship logo as provided for under the sponsorship agreement between China Netcom Group and BOCOG. The consideration of the Cooperation Agreement is RMB480 million.

(2) Continuing connected transactions

As of the date of this report, China Netcom Group, as the ultimate controlling shareholder of the Company, beneficially owned 70.49% of the Company's issued share capital. China Netcom Group is therefore a connected person of the Company. In October 2004, CNC China, a wholly owned subsidiary of the Company, entered into certain agreements with China Netcom Group, and certain ongoing transactions between CNC China on the one hand and China Netcom Group and its subsidiaries or associates (other than the Group) on the other ("**Continuing connected transactions relating to CNC China**") were conducted in accordance with the provisions under the aforesaid agreements up to 31 October 2005. In order to facilitate the management of all continuing connected transactions of the Company in China after the completion of the Acquisition, New Horizon Communications, CNC China and China Netcom Group entered into certain connected transaction agreement on 12 September 2005 to regulate the continuing connected transactions between China Netcom Group and its subsidiaries or associates (other than the Group) on one hand and the Group on the other in respect of the Group's operations in 12 provinces, autonomous region and municipalities in China, and these agreements would replace the existing connected transaction agreements between CNC China and China Netcom Group after the completion of the Acquisition. Certain ongoing transactions between CNC China and New Horizon Communications on the one hand and China Netcom Group and its subsidiaries or associates (other than the Group) on the other as from 31 October 2005 ("**Continuing connected transactions relating to CNC China and New Horizon Communications**") were conducted in accordance with the provisions under the new agreements.



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On 30 June 2004, Asia Netcom Corporation Limited ("**Asia Netcom**"), a wholly owned subsidiary of the Company, entered in certain transactions and a series of connected transaction agreements with East Asia Netcom Ltd. ("**EANL**"), a connected person of the Company by virtue of being an indirect wholly owned subsidiary of China Netcom Group.

These transactions between CNC China, New Horizon Communications and China Netcom Group and between Asia Netcom and EANL (the "**Continuing Connected Transactions**") constitute continuing connected transactions of the Company under the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Ltd (the "**Listing Rules**"). Details of the Continuing Connected Transactions are set out below and in note 40 to the financial statements regarding relative transactions with ultimate holding company, fellow subsidiaries and other related companies. For the financial year ended 31 December 2005, the Continuing Connected Transactions have not exceeded their respective upper limits set by the Hong Kong Stock Exchange. In respect of all the connected transactions of the Company as stated in this report, the Company has complied with the disclosure requirements under the Listing Rules in force from time to time.

Continuing connected transactions relating to CNC China

The following continuing connected transaction agreements took effect until the completion of Acquisition.

Interconnection Settlement Agreement

CNC China and China Netcom Group agreed to interconnect their respective networks and settle the charges received in respect of domestic and international long distance voice services within their respective service regions on a monthly basis.

For domestic long distance voice services between China Netcom Group and CNC China (except services between subsidiaries of China Netcom Group in four provinces and autonomous region and the branch companies of CNC China in six provinces and municipalities), the telephone operator in the location of the calling party makes a settlement payment to the telephone operator in the location of the called party at the rate of RMB0.06 per minute or RMB0.09 per minute (depending on whether the call terminates within or outside the network of either party).

For outbound international calls, China Netcom Group reimburses CNC China for any amount it has paid to overseas telecommunications operators. The revenues received by China Netcom Group less the amount paid to overseas telecommunications operators are shared between China Netcom Group and CNC China in proportion to the estimated costs incurred by each party.

For inbound international calls, the revenues received by CNC China from overseas telecommunications operators less the amount paid to China Netcom Group at the rate of RMB0.06 per minute or RMB0.09 per minute (depending on whether the call terminates within the network of China Netcom Group or other operators) are shared between China Netcom Group and CNC China in proportion to the estimated costs incurred by each party.

The rates of RMB0.06 per minute and RMB0.09 per minute mentioned above may be adjusted with reference to the relevant standards, tariffs or policies promulgated by the relevant regulatory authorities in China from time to time.

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Property Leasing Agreement

Pursuant to the Property Leasing Agreement:

- (i) CNC China leases to China Netcom Group certain properties located throughout the Company's northern service region and southern service region, for use as offices and other ancillary purposes; and
- (ii) China Netcom Group leases to CNC China certain properties located throughout the Company's northern service region and southern service region, for use as offices, telecommunications equipment sites and other ancillary purposes.

The charges payable by CNC China and by China Netcom Group under the Property Leasing Agreement are based on market rates or the depreciation and maintenance charges in respect of each property, provided such depreciation and maintenance charges shall not be higher than the market rates. The charges are payable quarterly in arrears and are subject to review every year to take into account the then prevailing market rates.

Property Sub-leasing Agreement

China Netcom Group agreed to sub-let to CNC China certain properties owned by and leased from independent third parties, for use as offices, telecommunications equipment sites and other ancillary purposes.

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The amounts payable by CNC China under the Property Sub-leasing Agreement are the same as the rental charges and other fees (including management fees) payable by China Netcom Group to the relevant third parties.

Master Services Sharing Agreement

Pursuant to the Master Services Sharing Agreement:

- (i) CNC China agreed to provide customer relationship management services, network management services and supporting services such as billing and settlement to China Netcom Group, and to share with China Netcom Group the services provided by the administrative and managerial staff at the headquarters of CNC China in respect of the central management of both CNC China and China Netcom Group; and
- (ii) China Netcom Group agreed to provide to CNC China supporting services, including telephone card production, development and related services and IC card inter-provincial and inter-network clearing services, and certain other shared services, and to provide certain office space in Beijing to CNC China for use as its principal executive office.

The above services are shared between CNC China and China Netcom Group on an on-going basis from time to time and the aggregate costs incurred by CNC China or China Netcom Group for the provision of such services are apportioned between CNC China and China Netcom Group according to the annual revenues generated by each party.



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Engineering and Information Technology Services Agreement

The Engineering and Information Technology Services Agreement govern the arrangements with respect to the provision of certain engineering and information technology-related services to CNC China by China Netcom Group, including planning, surveying and design services, construction services and supervision services in relation to telecommunications engineering projects, and information technology services.

The charges payable for such services are determined with reference to market rates. In addition, where the value of any single item of services exceeds RMB0.5 million (for design or supervision-related services), or where the value of any single item of services exceeds RMB2 million (for construction-related services), the award of such services will be subject to tender. The charges are settled between CNC China and China Netcom Group as and when the relevant services are provided.

Materials Procurement Agreement

Under the Materials Procurement Agreement, CNC China may request China Netcom Group to act as its agent for the procurement of imported and domestic telecommunications equipment and other domestic non-telecommunications equipment, and may purchase from China Netcom Group certain products. China Netcom Group also agreed to provide to CNC China related storage and transportation.

Commission and/or charges are not to exceed the maximum rate of 3 per cent. of the contract value for the domestic materials procurement services and 1 per cent. of the contract value for imported materials procurement services. The price for the purchase of China Netcom Group's products is determined with reference to the following pricing principles and limits ("**Pre-Acquisition Pricing Principles**"):

- (a) The government-fixed price;
- (b) Where item (a) does not apply, the government guidance price;
- (c) Where items (a) and (b) do not apply, the market price; or
- (d) Where none of the above is applicable, the price to be agreed between the relevant parties and determined on a cost-plus basis.

Commission charges for the storage and transportation services are determined with reference to market rates.

Payments under the Materials Procurement Agreement will be made as and when the relevant equipment or products have been procured and delivered.

Ancillary Telecommunications Services Agreement

The Ancillary Telecommunications Services Agreement govern the arrangements with respect to the provision of certain ancillary telecommunications services to CNC China by China Netcom Group, including certain telecommunications pre-sale, on-sale and after-sale services.

The charges payable for the services described above are determined with reference to the Pre-Acquisition Pricing Principles. The service charges are settled between CNC China and China Netcom Group as and when the relevant services are provided.

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Support Services Agreement

Under the Support Services Agreement, China Netcom Group provide CNC China with various support services, including equipment leasing and maintenance services, motor vehicles services, security services, basic construction agency services, research and development services, employee training services and advertising services.

The charges payable for the services described above are determined with reference to the Pre-Acquisition Pricing Principles. The service charges are settled between CNC China and China Netcom Group as and when relevant services are provided.

Telecommunications Facilities Leasing Agreement

Under the Telecommunications Facilities Leasing Agreement, China Netcom Group leases inter-provincial fibre-optic cables within the Company's northern and southern service regions and certain international telecommunications resources (including international telecommunications channel gateways, international telecommunications service gateways, international submarine cable capacity, international land cables and international satellites facilities) to CNC China.

The rental charges for the leasing of inter-provincial fibre-optic cables and international telecommunications resources are based on the annual depreciation charges of such fibre-optic cables and resources, and are settled between CNC China and China Netcom Group on a quarterly basis.

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Continuing connected transactions relating to CNC China and New Horizon Communications

The following continuing connected transaction agreements have come into effect only after the completion of Acquisition.

Domestic Interconnection Settlement Agreement

Pursuant to the Domestic Interconnection Settlement Agreement:

New Horizon Communications, CNC China (New Horizon Communications and CNC China are collectively referred to as the "**Combined Operating Group**") and China Netcom Group agreed to interconnect the network of China Netcom Group on the one hand and that of the Combined Operating Group on the other and settle the charges received in respect of domestic long distance voice services within their respective service regions on a quarterly basis.

For domestic long distance voice services between China Netcom Group and the Combined Operating Group, the telephone operator in the location of the calling party makes a settlement payment to the telephone operator in the location of the called party at the rate of RMB0.06 per minute (in case where the call terminates within the network of either China Netcom Group or the Combined Operating Group) or RMB0.09 per minute (in case where the call terminates outside the network of either China Netcom Group or the Combined Operating Group).

The rates of RMB0.06 per minute and RMB0.09 per minute mentioned above shall be adjusted with reference to the relevant standards, tariffs or policies formulated by the relevant regulatory authorities in China from time to time.



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International Long Distance Voice Services Settlement Agreement

Pursuant to the International Long Distance Voice Services Settlement Agreement:

CNC China and China Netcom Group agreed to interconnect the networks of China Netcom Group and CNC China and settle the charge received in respect of international long distance voice services on a quarterly basis.

For outbound international calls, China Netcom Group reimburses CNC China for any amount it has paid to overseas telecommunications operators. The revenues received by China Netcom Group less the amount paid to overseas telecommunications operators are shared between China Netcom Group and CNC China in proportion to the estimated costs incurred by China Netcom Group and the Combined Operating Group in connection with the provision of outbound international long distance voice services.

For inbound international calls, the revenues received by CNC China from overseas telecommunications operators (other than the Company and its controlled entities) less the amount paid to China Netcom Group at the rate of RMB0.06 per minute (in case where the call terminates within the network of China Netcom Group) or RMB0.09 per minute (in case where the call terminates within the network of other operators) are shared between China Netcom Group and CNC China in proportion to the estimated costs incurred by China Netcom Group and the Combined Operating Group in connection with the provision of inbound international long distance voice services.

The rates of RMB0.06 per minute and RMB0.09 per minute mentioned above shall be adjusted with reference to the relevant standards, tariffs or policies formulated by the relevant regulatory authorities in China from time to time.

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Property Leasing Agreement

Pursuant to the Property Leasing Agreement:

- (i) The Combined Operating Group leases to China Netcom Group some certain properties located throughout the Combined Operating Group's service regions, for use as offices and other ancillary purposes; and
- (ii) China Netcom Group leases to the Combined Operating Group some certain properties located throughout the Combined Operating Group's service regions, for use as offices, telecommunications equipment sites and other ancillary purposes.

The charges payable by the Combined Operating Group and by China Netcom Group are based on market rates or the depreciation and maintenance charges in respect of each property, provided such depreciation and maintenance charges shall not be higher than the market rates. The charges are payable quarterly in arrears and are subject to review every year to take into account the then prevailing market rates of the properties leased in that year.

Property Sub-leasing Agreement

Pursuant to the Property Sub-leasing Agreement:

China Netcom Group agreed to sub-let to the Combined Operating Group certain properties owned by and leased from independent third parties, for use as offices, telecommunications equipment sites and other ancillary purposes.

The amounts payable by the Combined Operating Group under the Property Sub-leasing Agreement are the same as the rental charges and other fees (including management fees) payable by China Netcom Group to the relevant third parties.

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Master Sharing Agreement

Pursuant to the Master Sharing Agreement:

- (a) The Combined Operating Group will provide customer relationship management services for large enterprise customers of China Netcom Group;
- (b) The Combined Operating Group will provide network management services to China Netcom Group;
- (c) The Combined Operating Group will share with China Netcom Group the services provided by administrative and managerial staff in respect of central management of the business operations, financial control, operation and maintenance of network, human resources and other related matters of both the Combined Operating Group and China Netcom Group;
- (d) The Combined Operating Group will provide to China Netcom Group supporting services such as billing and settlement provided by the business support centre;
- (e) China Netcom Group will provide to the Combined Operating Group supporting services, including telephone card production, development and related services and IC card inter-provincial and inter-network clearing services;
- (f) China Netcom Group will provide to the Combined Operating Group certain other shared services, including advertising, publicity, research and development, business hospitality, maintenance and property management; and
- (g) China Netcom Group will provide certain office space in its headquarters to the Combined Operating Group for use as its principal executive office.
- (h) The Combined Operating Group and China Netcom Group will share the revenues received by China Netcom Group from other operators whose networks interconnect with the Internet backbone network of China Netcom Group and will share the monthly connection fee that China Netcom Group pays to the State Internet Switching Centre.

The Combined Operating Group and China Netcom Group own certain equipment and facilities forming the Internet backbone network of China Netcom Group. This Internet backbone network interconnect with the networks of other operators. Such interconnection generates revenue which is settled with China Netcom Group and shared between China Netcom Group and the Combined Operating Group under the Master Sharing Agreement.

The services set out in paragraphs (a) to (g) above and the revenue and fee set out in paragraph (h) above are shared between the Combined Operating Group and China Netcom Group on an on-going basis from time to time and the aggregate costs incurred by the Combined Operating Group or China Netcom Group for the provision of the services set out in paragraphs (a) to (g) above and the revenue and fee receivable and payable by China Netcom Group as referred to in paragraph (h) above are apportioned between the Combined Operating Group and China Netcom Group according to their respective total assets value as shown in their respective financial statements on an annual basis.

Engineering and Information Technology Services Agreement

The Engineering and Information Technology Services Agreement governs the arrangements with respect to the provision of certain engineering and information technology-related services to the Combined Operating Group by China Netcom Group, which include planning, surveying and design services in relation to telecommunications engineering projects, construction services in relation to telecommunications engineering projects, supervision services in relation to telecommunications engineering projects and information technology services.



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The charges payable for engineering and information technology-related services described above are determined with reference to market rates. In addition, where the value of any single item of engineering design or supervision-related service exceeds RMB0.5 million or where the value of any single item of engineering construction-related service exceeds RMB2 million, the award of such services will be subject to tender. The charges are settled between the Combined Operating Group and China Netcom Group as and when the relevant services are provided.

Materials Procurement Agreement

Pursuant to the Materials Procurement Agreement, the Combined Operating Group may request China Netcom Group to act as its agent for the procurement of imported and domestic telecommunications equipment and other domestic non-telecommunications equipment, and may purchase from China Netcom Group certain products, including cables, modems and yellow pages telephone directories. China Netcom Group further agreed to provide to the Combined Operating Group storage and transportation services related to the procurement and purchase of materials or equipment.

Commission and/or charges for the domestic materials procurement services shall not exceed the maximum rate of 3% of the contract value. Commission and/or charges for the above imported materials procurement services shall not exceed the maximum rate of 1% of the contract value. The price for the purchase of China Netcom Group's products is determined with reference to the following principles and limits (the "Post-Acquisition Pricing Principles"):

- (a) the government fixed price;
- (b) where there is no government fixed price but a government guidance price exists, the government guidance price;
- (c) where there is neither a government fixed price nor a government guidance price, the market price; or
- (d) where none of the above is applicable, the price to be agreed between the relevant parties and determined on a cost-plus basis.

Commission charges for the storage and transportation services are determined with reference to market rates.

Payments under the Materials Procurement Agreement will be made as and when the relevant equipment or products have been procured and delivered.

Ancillary Telecommunications Services Agreement

The Ancillary Telecommunications Services Agreement governs the arrangements with respect to the provision of ancillary telecommunications services to the Combined Operating Group by China Netcom Group, which include certain telecommunications pre-sale, on-sale and after-sale services, sales agency services, printing and invoice delivery services, maintenance of telephone booths, customers acquisition and servicing and other customers' services.

The charges payable for the services described above are determined with reference to the Post-Acquisition Pricing Principles, and the service charges are settled between the Combined Operating Group and China Netcom Group as and when the relevant services are provided.

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Support Services Agreement

Pursuant to the Support Services Agreement, China Netcom Group provides the Combined Operating Group with various support services, including equipment leasing (other than equipment covered under the Telecommunications Facilities Leasing Agreement) and maintenance services, motor vehicles services, security services, basic construction agency services, research and development services, employing training services and advertising services and other support services.

The charges payable for the services described above are determined with reference to the Post-Acquisition Pricing Principles, and are settled between the Combined Operating Group and China Netcom Group as and when relevant services are provided.

Telecommunications Facilities Leasing Agreement

Pursuant to the Telecommunications Facilities Leasing Agreement, China Netcom Group leases inter-provincial fiber-optic cables within the Combined Operating Group's service regions to the Combined Operating Group, and leases certain international telecommunications resources (including international telecommunications channel gateways, international telecommunications service gateways, international submarine cable capacity, international land cables and international satellite facilities) to the Combined Operating Group, and China Netcom Group leases certain other telecommunications facilities required by the Combined Operating Group for its operations.

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The rental charges and service charges for the leasing of inter-provincial fiber-optic cables, international telecommunications resources and other telecommunications facilities are based on the annual depreciation charges of such fiber-optic cables, resources and telecommunications facilities provided that such charges shall not be higher than market rates. The Combined Operating Group shall be responsible for the on-going maintenance of such inter-provincial fiber-optic cables and international telecommunications resources. The Combined Operating Group and China Netcom Group shall determine and agree on which party is to provide maintenance services to the other telecommunications facilities leased by China Netcom Group to the Combined Operating Group based on the latter's operational requirements. Unless otherwise agreed by the Combined Operating Group and China Netcom Group, such maintenance service charges shall be borne by the Combined Operating Group. If China Netcom Group shall be responsible for maintaining the other telecommunications facilities that it leases to the Combined Operating Group based on the latter's operational requirements, the Combined Operating Group shall pay to China Netcom Group the relevant maintenance service charges which shall be determined with reference to market rates. Where there are no market rates, the maintenance charges shall be agreed between the parties and determined on a cost-plus basis. The net rental charges and service charges due to China Netcom Group under the Telecommunications Facilities Leasing Agreement will be settled between the Combined Operating Group and China Netcom Group on a quarterly basis.

Continuing connected transactions relating to Asia Netcom

Capacity Purchase Agreement

Asia Netcom and its subsidiaries receive from EANL and its subsidiaries a certain amount of long-term telecommunications capacity on the submarine network. The purchased capacity consists of (i) an initial fixed amount of capacity; (ii) an additional amount of capacity up to a maximum figure to be activated upon written notice to EANL; and (iii) further additional amount of capacity that may be ordered within three years following the date of the Capacity Purchase Agreement.

The charges payable by Asia Netcom to EANL for the initial capacity and charges payable for the additional capacity activated are based on market rates determined by reference to a similar transaction between Asia Netcom and a third party in January 2004 ("**Benchmark Transaction**") duly adjusted to take into account of advance receipt of payment prior to the delivery of the capacity. The pricing of the further additional capacity is to be determined between Asia Netcom and EANL prior to the placement of the actual order for such capacity.



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In addition to the above charges, Asia Netcom pays EANL an annual operation and maintenance fee equal to 4% of the total charges payable by Asia Netcom to EANL for the capacity activated and ordered under the Capacity Purchase Agreement (in so far as such capacity has not been terminated) which is based on current market rate.

Capacity Lease Agreement

Pursuant to the Capacity Lease Agreement with EANL, Asia Netcom and its subsidiaries lease from EANL and its subsidiaries a fixed amount of capacity on EANL's telecommunications network, and may order additional lease capacity from EANL and its subsidiaries.

EANL and its subsidiaries agreed to permit Asia Netcom or any of its subsidiaries to interconnect its communications system with the leased capacity, and to connect such amount of capacity to the facilities of its backhaul suppliers and/or local exchange carrier. Furthermore, upon request by Asia Netcom, EANL and its subsidiaries are to use their best efforts to provide to Asia Netcom or its subsidiaries with local connectivity with end-users in jurisdictions where Asia Netcom or its subsidiaries are not otherwise authorised to provide services.

The charges payable by Asia Netcom to EANL for the initial lease capacity are determined based on market rates by reference to the Benchmark Transaction, as adjusted to take into account the particular circumstances under the Capacity Lease Agreement. The pricing for any additional lease capacity is to be agreed by Asia Netcom and EANL prior to the order for such capacity. These charges are payable quarterly in arrears.

The connections charges payable by Asia Netcom to EANL is the pro rata share of reasonable and actual expenses incurred by EANL in making such connections. The local connectivity charges payable by Asia Netcom to EANL is EANL's lowest wholesale price without discount, or, if the local connectivity is provided by an unrelated carrier, the amount charged to EANL by such unrelated carrier, without surcharge. Such charges for local connectivity are payable quarterly in arrears.

Management Services Agreement

Pursuant to the Management Services Agreement, Asia Netcom and its subsidiaries provide EANL and its subsidiaries with certain services, including government and corporate affairs services, treasury services, financial services, information technology services, legal and corporate secretarial services, tax services, payment services, and comprehensive engineering and operation services in relation to the submarine network.

The charges payable for the above services (except for the payment services) are determined on the basis of costs plus reasonable profits, but cannot exceed the market price for the provision of such services.

The charges payable for the payment services are the amounts required to reimburse all payments made by Asia Netcom and its subsidiaries on behalf of EANL and its subsidiaries in performing such services.

In the opinion of the independent non-executive directors, the Continuing Connected Transactions were entered into by the Group:

- (i) in the ordinary and usual course of its business;
- (ii) either on normal commercial terms or, where there are no sufficient comparables, on terms no less favourable than the terms the Company could have obtained from an independent third party; and
- (iii) in accordance with the relevant agreements governing such transactions and on terms that are fair and reasonable and in the interests of the shareholders of the Company as a whole.

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The board of directors has received a letter from the auditors of the Company stating that the Continuing Connected Transactions:

- (A) have received the approval of the Company's board of directors;
- (B) were carried out in accordance with the pricing policy as stated in note 40 to the financial statements for the year ended 31 December 2005;
- (C) have been entered into in accordance with the relevant agreements governing the Continuing Connected Transactions; and
- (D) have not exceeded their respective upper limits set by the Hong Kong Stock Exchange for the financial year ended 31 December 2005.

Directors

The directors for this financial year are:

Executive Directors

Zhang Chunjiang

Tian Suning

Zhang Xiaotie

Miao Jianhua

Jiang Weiping

(re-designated as an Executive Director on 7 December 2005)

Non-executive Directors

Li Liming

José María Álvarez-Pallete

Keith Rupert Murdoch

Yan Yixun

(appointed on 12 September 2005)

(resigned on 12 September 2005)

Independent Non-executive Directors

John Lawson Thornton

Victor Cha Mou Zing

Qian Yingyi

Hou Ziqiang

Timpson Chung Shui Ming

Alternate Director

Mauricio Sartorius

(alternate to Mr. José María Álvarez-Pallete)

(appointed on 12 September 2005)



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In accordance with Article 99 of the Company's Articles of Association, Mr. Zhang Xiaotie, Mr. Miao Jianhua, Mr. John Lawson Thornton, and Mr. Victor Cha Mou Zing will retire by rotation at the forthcoming annual general meeting of the Company and, being eligible, offer themselves for re-election. In accordance with Article 103 of the Company's Articles of Association, Mr. José María Álvarez-Pallete will also retire at the forthcoming annual general meeting and, being eligible, offer himself for re-election.

The biographical details of the directors proposed for re-election at the forthcoming annual general meeting ("**Directors for Re-election**") are set out on pages 16 to 18. Except as disclosed in such biographical details, the Directors for Re-election have not held any other directorships in any listed public companies in the last three years. Further, except as noted in the biographical details, none of the Directors for Re-election is connected with any directors, senior management or substantial or controlling shareholders of the Company and, except for the share options granted to the Directors for Re-election (other than Mr. John Lawson Thornton, Mr. Victor Cha Mou Zing and Mr. José María Álvarez-Pallete) as set out in the paragraph "Share option scheme" below, none of them has any interests in the shares of the Company within the meaning of Part XV of the Securities and Futures Ordinance ("**SFO**").

The service contracts for Mr. Zhang Xiaotie and for Mr. Miao Jianhua do not provide for a specified length of services. Mr. John Lawson Thornton, Mr. Victor Cha Mou Zing and Mr. José María Álvarez-Pallete have not entered into any service contract with the Company. Each of the Directors for Re-election will be subject to retirement by rotation and re-election at annual general meetings of the Company every three years. Each of such directors is entitled to an annual director's fee of HK\$250,000 as proposed by the board of directors and approved by the shareholders of the Company at the annual general meeting held on 20 May 2005. Director's fees are payable on a time pro-rata basis for any non full year's service. In addition, Mr. John Lawson Thornton is entitled to an additional annual fee of HK\$100,000 as a member of the Compensation and Nomination Committee and the Corporate Governance Committee, Mr. Victor Cha Mou Zing is entitled to an additional annual fee of HK\$100,000 as a member of the Audit Committee and the Compensation and Nomination Committee and Mr. José María Álvarez-Pallete is entitled to an additional annual fee of HK\$50,000 as a member of the Strategic Planning Committee.

None of the Directors for Re-election has an unexpired service contract which is not determinable by the Company or any of its subsidiaries within one year without payment of compensation, other than under normal statutory obligations.

Save as disclosed herein, there are no other matters relating to the re-election of the Directors for Re-election that need to be brought to the attention of the shareholders of the Company nor there is any information to be disclosed pursuant to any of the requirements of Rule 13.51(2) of the Listing Rules.

Directors' interests in contracts

No contract of significance to which the Company, its holding company, or any of its fellow subsidiaries or subsidiaries was a party and in which a director of the Company had a material interest, whether directly or indirectly, subsisted at the end of the year or at any time during the year.

Directors' interest in competing businesses

China Netcom Group is engaged in fixed-line telecommunications business and other related businesses in the PRC and Asia-Pacific which are similar to that of the Company. The executive directors of the Company also hold executive positions with China Netcom Group. On 6 September 2004, China Netcom Group, the Company and CNC China entered into a non-competition agreement, under which China Netcom Group undertakes not to compete with the Company in the businesses as prescribed in the agreement without the Company's prior written consent.

Report of the Directors

Mr. Zhang Chunjiang and Dr. Tian Suning, the Company's executive directors, have served as directors in PCCW Limited since 1 April 2005. Mr. José María Álvarez-Pallete is a Director of Telefónica de España, Telefónica Móviles, Telefónica Móviles España, Telefónica Data, Telefónica Internacional, Telefónica de Argentina, Telefónica CTC Chile, Telefónica de Perú, Compañía de Teléfonos de Chile Transmisiones Regionales, Telefónica Larga Distancia de Puerto Rico, Telesp and Cointel. In addition, he is a member of the supervisory board of Cesky Telecom. Apart from the above, none of the directors of the Company is or was interested in any business, apart from the Company's business, that competes or competed or is or was likely to compete, either directly or indirectly, with the Company's business at any time during the 2005 financial year up to and including the date of this report.

Directors' and chief executive's interest and short positions in shares, underlying shares and debentures

Certain directors of the Company personally hold options to subscribe for ordinary shares of the Company. Details of such options are disclosed under the paragraph "Share option scheme" below. These share options were granted pursuant to the terms of the share option scheme adopted by the Company.

Apart from those disclosed herein, as at 31 December 2005, none of the directors nor the chief executive of the Company had any interests or short positions in any of the shares, underlying shares or debentures of the Company or any of its associated corporations (within the meaning of the SFO) that is required to be recorded and kept in the register in accordance with section 352 of the SFO, any interests required to be notified to the Company and the Stock Exchange pursuant to the Model Code for Securities Transactions by Directors of Listed Issuers ("**Model Code**").

Emolument policy

The emolument policy of the Company is based on the key principles of maintaining competitiveness in the market for talent, retaining talent and rewarding high performance. In line with these key principles, employees are remunerated with a combination of a basic salary, a performance-based bonus and a long-term incentive scheme in the form of a share option scheme for eligible employees, details of which can be found in the paragraph "Share option scheme" below.

The Company has established a Compensation and Nomination Committee, which is responsible for making recommendations to the Board on the Company's emolument policy and structure in relation to all directors, the chief executive officer and other executive officers. The Compensation and Nomination Committee determines the remuneration packages of executive directors and senior management, and make recommendations to the Board on the remuneration of non-executive directors. In making such determination, the Compensation and Nomination Committee considers factors such as salaries payable by comparable companies, the time commitment and responsibilities involved in the relevant position, employment conditions elsewhere in the group of companies to which the Company belongs and the desirability of performance-based remuneration with reference to corporate goals and objectives resolved by the Board from time to time. No director is involved in deciding his or her own remuneration.

Employee retirement benefits

Particulars of the employee retirement benefits of the Group are set out in note 4(q)(i) and note 14 to the financial statements.



Report of the Directors

Share option scheme

The shareholders of the Company passed a resolution on 30 September 2004 to approve and adopt the share option scheme (the “**Share Option Scheme**”). Having considered the changes following the completion of the Acquisition and for the purpose of clarifying the relevant scope of the Share Option Scheme, the Board convened a meeting on 6 December 2005 and made minor amendments to the Share Option Scheme.

The main contents of the amended Share Option Scheme are as follows:

(a) Purpose of the Share Option Scheme

The purpose of the Share Option Scheme is to provide the Company with a means to incentivise its senior management, to attract and retain talent and to encourage other eligible participants to enhance the value of the Company.

(b) Participants of the Share Option Scheme

The directors may invite any person belonging to any of the following classes of participants to take up options to subscribe for the ordinary shares of the Company:

- (i) the directors (including executive and non-executive directors);
- (ii) members of the middle-to-senior management; and
- (iii) such class of “specialised professionals” as may be designated by the Compensation and Nomination Committee.

For the purpose of sub-paragraph (b)(iii) above, “specialised professionals” means such professionals that are important to the development of the Group’s business and the management, technical and business development personnel that occupy key positions in the Group. The Compensation and Nomination Committee has the authority to interpret the meaning of “specialised professionals”.

(c) Maximum number of shares and effective options

- (i) The maximum number of shares which may be allotted and issued upon the exercise of all outstanding options granted and yet to be exercised under the Share Option Scheme and any other share option scheme must not in aggregate exceed 30 per cent. of the relevant class of securities of the Company in issue from time to time.
- (ii) The total number of shares which may be allotted and issued upon the exercise of all options to be granted under the Share Option Scheme must not in aggregate exceed 10 per cent. of the shares in issue immediately after the completion of the global offering of shares (and American depositary shares) of the Company in November 2004 (the “**General Scheme Limit**”).
- (iii) Subject to (c)(i) above, the Company may seek approval of the shareholders in general meeting to refresh the General Scheme Limit and may seek separate approval of the shareholders in general meeting to grant options beyond the General Scheme Limit.
- (iv) “Effective options” means the share options granted under the Share Option Scheme, irrespective of whether such options are exercisable in accordance with the relevant vesting schedule; and “vesting schedule” means the arrangement whereby options can be exercised by batch in accordance with the timetable pre-determined by the Share Option Scheme.

Report of the Directors

- (d) As at the date of this report, the total number of securities available for issue under the Share Option Scheme is 236,023,000, representing 3.6 per cent. of the issued share capital of the Company as at the date of this report.

(e) Maximum entitlement of each participant

Unless otherwise approved by the shareholders in general meeting, the total number of shares issued and which may fall to be issued upon the exercise of the options granted under the Share Option Scheme (including both exercised or outstanding options) to any participant in any 12-month period shall not exceed 0.2 per cent. of the issued share capital of the Company on the date of grant.

(f) Minimum period for which an option must be held before it can be exercised

With respect to the share options granted prior to the listing of the Company's shares on the Stock Exchange, there is a minimum period of 18 months from the later of the date of grant or the date of the listing of the shares on the Stock Exchange before an option can be exercised; with respect to the share options granted after the listing of the Company's shares on the Stock Exchange, there is a minimum period of 24 months from the later of the date of grant or the date of the listing of the shares on the Stock Exchange before an option can be exercised.

(g) Period within which the shares must be taken up under an option

Any option shall lapse if not exercised within 6 years from the later of the date of grant or the date of the listing and commencement of trading of the shares on the Stock Exchange.

(h) The basis of determining the exercise price for shares

The exercise price is a price determined by the directors but shall not be less than the highest of: (i) the closing price of the shares on the Stock Exchange on the date of grant; (ii) the average closing price of shares on the Stock Exchange for the five trading days immediately preceding the date of grant; and (iii) the nominal value of the shares.

(i) Consideration

No consideration is payable on acceptance of the grant of an option.

(j) The remaining life of the Share Option Scheme

Unless otherwise terminated by the Board of Directors in exercise of its power in accordance with the rules governing the Share Option Scheme, the Share Option Scheme will remain in force for a period of 10 years commencing on the date on which the Share Option Scheme is adopted.

(k) Amendment to and termination of the Share Option Scheme

- (i) The Board of the Company may amend any of the provisions of the Share Options Scheme and the terms of the options at any time, but not so as to prejudice the rights of the grantees of options.
- (ii) Any alterations to the matters set out in the Listing Rules and alterations which are to the advantage of existing or future grantees of options shall only be made with the approval of shareholders at general meeting.
- (iii) Any alterations to the terms and conditions of the Share Option Scheme which are of a material nature shall be approved by the shareholders of the Company at general meeting, except where the alterations take effect automatically under the existing terms of the Share Option Scheme.

Report of the Directors

- (iv) Any change to the authority of the Board in relation to alteration of the terms of the Share Option Scheme shall be approved by shareholders of the Company at general meeting. The amended Share Option Scheme or the terms thereof shall comply with the relevant requirements of the Listing Rules.
- (v) During the effective term of the Share Option Scheme, the Board may at any time terminate the Share Option Scheme or decide not to grant any options under the Share Option Scheme, and in such event the options granted under this Scheme (to the extent not already exercised) may still be exercisable pursuant to the rules of the Share Option Scheme or may be cancelled by the Board pursuant to rules thereof.
- (vi) The Share Option Scheme will be terminated upon the expiry of its effective term and any new share option scheme to be adopted by the Board shall be approved by the shareholders of the Company at general meeting.

As at 31 December 2005, the directors, chief executive and employees of the Company had the following personal interests in options to subscribe for shares of the Company granted under the Share Option Scheme.

	No. of shares involved in the options outstanding at the beginning of the year	No. of shares involved in the options outstanding at the end of the year	Date of the grant of the options	Price per share payable for the exercise of the options (in HK\$)
Directors				
Zhang Chunjiang	920,000	920,000	22 October 2004	8.40
Tian Suning (also the chief executive officer)	920,000	920,000	22 October 2004	8.40
Zhang Xiaotie	800,000	800,000	22 October 2004	8.40
Miao Jianhua	700,000	700,000	22 October 2004	8.40
Jiang Weiping	700,000	700,000	22 October 2004	8.40
Li Liming	700,000	700,000	22 October 2004	8.40
Yan Yixun	590,000	590,000	22 October 2004	8.40
(1) Employees and other persons granted with options after the completion of the Acquisition	—	79,320,000	6 December 2005	12.45
(2) Employees and other persons granted with options in 2004	152,390,000	151,373,000	22 October 2004	8.40
Total		236,023,000^(a)		

Report of the Directors

Notes:

- (a) The total number of shares involved in the options outstanding at the end of the year represents 3.6 per cent. of the issued share capital of the Company as at the date of this report.
- (b) Grantees of the share options granted on 22 October 2004 are entitled to exercise the options in the following periods:
- (i) in respect of 40 per cent. of the options granted, from 17 May 2006 to 16 November 2010;
 - (ii) in respect of a further 30 per cent. of the options granted, from 17 May 2007 to 16 November 2010; and
 - (iii) in respect of the remaining 30 per cent. of the options granted, from 17 May 2008 to 16 November 2010.
- (c) Options were granted by the Company on 6 December 2005. The closing price per share on the trading day immediately before 6 December 2005 was HK\$12.25.
- (d) Grantees of the share options granted on 6 December 2005 are entitled to exercise the options in the following periods:
- (i) in respect of 40 per cent. of the options granted, from 6 December 2007 to 5 December 2011;
 - (ii) in respect of a further 30 per cent. of the options granted, from 6 December 2008 to 5 December 2011; and
 - (iii) in respect of the remaining 30 per cent. of the options granted, from 6 December 2009 to 5 December 2011.
- (e) During the year ended 31 December 2005, no share option has been exercised and share options representing 1,017,000 shares lapsed as a result of the resignation of the employees to whom the share options were granted.

According to the requirements under HKFRS 2, the fair value of the options granted by the Company to its employees (including directors) to subscribe for shares in the Company shall be recognised as expenses in the Company's consolidated income statement. The Company has made retrospective adjustments to the recognized employee benefit costs or liabilities in relation to the grant of options to subscribe for shares in the Company to employees (including directors) in prior years.

Apart from the foregoing, at no time during the year ended 31 December 2005 was the Company, any of its holding companies or subsidiaries or fellow subsidiaries, a party for any arrangement to enable the directors or senior management of the Company or any of their spouses or children under eighteen years of age to acquire benefits by means of the acquisition of shares in or debentures of the Company or any other body corporate.

Substantial shareholders' and other persons' interests and short positions in shares and underlying shares

The Company has been notified of the following interests in the Company's issued shares as at 31 December 2005 amounting to 5 per cent. or more of the ordinary shares in issue:

	Number of ordinary shares interested		Percentage of total issued share capital
	directly	indirectly	(%)
China Network Communications Group Corporation	—	4,945,148,000 ⁽¹⁾⁽²⁾	75%
China Netcom Group Corporation (BVI) Limited	4,647,449,014 ⁽¹⁾	297,698,986 ⁽¹⁾⁽²⁾	75%
Telefónica Internacional S.A.	329,676,450	—	5%



Report of the Directors

Notes:

- (1) China Network Communications Group Corporation ("China Netcom Group") beneficially owns 4,647,449,014 shares held by its wholly owned subsidiary, China Netcom Group Corporation (BVI) Limited ("CNC BVI") and 1 share held by CNC Cayman, Limited, a wholly owned subsidiary of CNC BVI. The percentage of total issued share capital beneficially held by China Netcom Group is 70.49%.
- (2) China Netcom Group is deemed under the SFO to be interested in 297,698,985 shares held by CNC BVI as trustee on behalf of certain shareholders.

Apart from the foregoing, as at 31 December 2005, no person or corporation had any interest in 5 per cent. or more of or any short position in the issued share capital of the Company as recorded in the registers required to be kept under section 336 of the SFO.

Public Float

As at the date of this report, the Company has maintained the prescribed public float of not less than 23 per cent. of the issued share capital of the Company pursuant to the Listing Rules and as agreed with the Stock Exchange, based on the information that is publicly available to the Company and within the knowledge of the directors of the Company.

Auditors

A resolution for the reappointment of PricewaterhouseCoopers as auditors of the Company shall be proposed at the forthcoming annual general meeting.

By order of the board

Zhang Chunjiang

Executive Chairman

Hong Kong