Notes to the Consolidated Financial Statements

1 The Group and its principal activities

Background of the Group

China Netcom Group Corporation (Hong Kong) Limited (the "Company") was incorporated in the Hong Kong Special Administrative Region ("Hong Kong") of the People's Republic of China ("PRC") on October 22, 1999 as a limited liability company under the Hong Kong Companies Ordinance. The shares of the Company were listed on The Stock Exchange of Hong Kong Limited on November 17, 2004 and the ADSs of the Company were listed on The New York Stock Exchange Inc. on November 16, 2004. Prior to a reorganization conducted for the listing of the shares of the Company (the "Listing Reorganization"), the Company's ultimate holding company was China Netcom (Holdings) Company Limited ("China Netcom Holdings").

The Company, China Netcom Holdings and China Network Communications Group Corporation (the "China Netcom Group") underwent reorganization on June 30, 2004. China Netcom Group, established by the State Council of the PRC ("State Council") in May 2002, was formed under a restructuring plan approved by the State Council based on the fixed line telecommunication section from the Northern operations originally operated by China Telecommunication Corporation ("China Telecom Group"). Immediately after the Listing Reorganization, China Netcom Group became the ultimate holding company of the Group and the Company and its subsidiaries (the "Group") owned the assets and liabilities of fixed line telecommunications businesses originally owned by China Netcom Group in the six northern provinces and municipalities (namely Beijing Municipality, Tianjin Municipality, Hebei Province, Liaoning Province, Shandong Province and Henan Province) and two southern province and municipality (namely Shanghai Municipality and Guangdong Province) in the PRC and the assets and liabilities of fixed line telecommunications business in Asia Pacific Region originally owned by the Group.

Pursuant to a resolution passed at the extraordinary general meeting of the shareholders on October 25, 2005, the Company acquired the principal telecommunications operations, assets and liabilities in the four Northern provinces/autonomous region, namely Shanxi Province, Neimenggu Autonomous Region, Jilin Province and Heilongjiang Province from China Netcom Group. In anticipation of the acquisition, China Netcom Group established China Netcom Group New Horizon Communications Corporation (BVI) Limited ("New Horizon (BVI)") and China Netcom Group New Horizon Communications Corporation Limited ("New Horizon Communications"). China Netcom Group's fixed line telecommunications businesses in the four northern provinces/autonomous region were transferred to New Horizon (BVI) through a group restructuring. Upon the completion of the acquisition of the entire interest of New Horizon (BVI) and New Horizon Communications from China Netcom Group (hereinafter the "Acquisition of New Horizon'), the Company controlled the fixed line telecommunications businesses in the four Northern provinces/autonomous region. On November 3, 2006, New Horizon Communications was deregistered and its operations were merged into the Company's wholly owned subsidiary, China Netcom (Group) Company Limited ("CNC China"). The Group leased from China Netcom Group the inter-provincial fiber-optic cables of the service regions the Group operates in the PRC and which had been retained from China Netcom Group.

After taking into consideration the financial position and prospects of the acquired businesses and the conditions of the capital market, the consideration for Acquisition of New Horizon was determined at RMB12,800 million. The consideration consists of an initial cash payment of RMB3,000 million and deferred payments of RMB9,800 million. The deferred payments will be settled in half-yearly installments over five years. The interest charged on the deferred payments is to be calculated at 5.265% per annum.

Following the Listing Reorganization and the Acquisition of New Horizon, the Group is the dominant provider of fixed line telephone services, broadband, other internet-related services, and business and data communications services in ten northern provinces, municipalities and autonomous region, namely Beijing Municipality, Tianjin Municipality, Hebei Province, Liaoning Province, Shandong Province, Henan Province, Shanxi Province, Neimenggu Autonomous Region, Jilin Province, and Heilongjiang 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 the PRC.

1 The Group and its principal activities *(continued)*

Background of the Group *(continued)*

The Group is also the holder of licenses that are necessary to own and operate the assets held outside the PRC in such key countries and regions such as United States, Hong Kong and Japan.

The Group's PRC operations are subject to the supervision of and regulation by the PRC Government. The Ministry of Information Industry ("MII"), pursuant to the authority delegated by the State Council, is responsible for formulating the telecommunications industry policies and regulations (the "Telecommunications Regulations").

Under the Telecommunications Regulations, all telecommunications operators in the PRC must obtain a telecommunications service operating license from the MII or from the provincial telecommunications administrations. Providers of value-added services within a single province are required to obtain licenses from provincial telecommunications administrations. Providers of basic telecommunications services and providers of value-added services in two or more provinces, autonomous regions and municipalities are required to obtain licenses from the MII. CNC China, the Group's principal operating subsidiary in China, as an indirect subsidiary of China Netcom Group, has the right to operate the Group's telecommunications business in twelve service regions under the authorization of China Netcom Group, which holds the license required for operating the Group's telecommunications businesses in the PRC.

On June, 2, 2006, the Group entered into an agreement with third party buyers to dispose of its entire interest in the Asia Netcom Corporation Limited (the "ANC Group") for an aggregate cash consideration of US$168.84 million, at fair value determined by both parties. The transaction was completed on August 22, 2006.

Currently, the Group's principal services consist of:

- Fixed line telephone services (including the personal handy phone system (PHS) services), comprising:
  - (a) Local, domestic long distance and international long distance services;
  - (b) Value-added services, including caller identity, telephone information services; and
  - (c) Interconnection services provided to other domestic telecommunications service providers including the fellow subsidiary owned by China Netcom Group operating outside the twelve service regions;
- Broadband services and other Internet-related services;
- Information Communications Technology Services, including system integration, software development, maintenance services, consultancy services, product sales and agency services, and equipment leasing services;
- Business and data communications services, including integrated regional data and voice communications services.

2 Basis of presentation

The financial statements have been prepared in accordance with Hong Kong Financial Reporting Standards ("HKFRS"), Hong Kong Accounting Standards ("HKAS") and interpretations issued by the Hong Kong Institute of Certified Public Accountants (''HKICPA''). They have also been prepared in accordance with the disclosure requirements of the Companies Ordinance and Rules Governing the Listing Securities on The Stock Exchange of Hong Kong Limited. They have been prepared under the historical cost convention modified by the revaluation of certain fixed assets as explained in the accounting policies in Note 4 below, and on a going concern basis.

A significant percentage of the Group's funding requirements is achieved through short term borrowings. Consequently, the balance sheet indicates a significant working capital deficit. In the past, a substantial portion of the Group's short term borrowings have been rolled over upon maturity. In addition, on July 20, 2006, the Group issued commercial papers to raise additional funding of RMB10 billion. Based on the Group's history of obtaining finance, its relationships with its bankers and its operating performance, the board of directors consider that the Group will continue to be able to roll over such short term financing, or will be able to obtain sufficient alternative sources of financing to enable it to operate and meet its liabilities as and when they fall due.

Since the Group disposed of the ANC Group during the year, in accordance with HKFRS 5"Non-current assets held for sale and discontinued operations" issued by the HKICPA, the results and cash flows of the operations of the ANC Group have been presented as discontinued operations. The 2005 comparative figures in the income statement and statement of cash flow are restated accordingly.

3 Changes in accounting policies

In 2006, the Group adopted certain revised HKFRSs which are relevant to its operations as listed below.

- HKAS 21(Amendment) - Net investment in a Foreign Operation
- HKAS 39(Amendment) - Cash Flow Hedge Accounting for Forecast Intragroup Transactions
- HKAS 39(Amendment) - Fair Value Options
- HKAS 39(Amendment) and HKFRS 4(Amendment) - Financial guarantee contracts

The adoption of these new and revised HKFRSs by the Group did not have any significant impact on its results of operations and financial position.

The HKICPA has also issued a number of new and revised HKFRSs which are relevant to the Group's operation as set out below which are effective for accounting periods beginning on or after January 1, 2007. The Group has not early adopted these new or revised HKFRSs in the financial statements for the year ended December 31, 2006. The Group has commenced an assessment of the impact of these new and revised HKFRSs, but is not yet in a position to state whether these new and revised HKFRSs would have a significant impact on its results of operations and financial position.

- HKFRS 7 - Financial Instruments : Disclosures
- HKAS 1 (Amendment) - Presentation of Financial Statements: Capital Disclosure
- HK(IFRIC) - Int 8 - Scope of HKFRS 2
- HK(IFRIC) - Int 10 - Interim Reporting and Impairment

4 Principal accounting policies

(a) Basis of consolidation

Acquisitions of businesses under common control are accounted for using merger accounting in accordance with Accounting Guideline 5 issued by HKICPA. The acquired assets are stated at carrying amounts as if the assets have been held by the Company from the beginning of the earliest period presented.

Acquisitions of subsidiaries from third parties are accounted for using acquisition accounting. The results and financial positions of such subsidiaries acquired or disposed of during the year are included in the consolidated income statements from the effective date of acquisition or up to the effective date of disposal, as appropriate.

When a subsidiary is disposed, the difference between the proceeds from the disposal of the subsidiary and its carrying amount as of the date of disposal, including the cumulative amount of any exchange differences that relates to the subsidiary recognized in equity is recognized in the consolidated income statement as the gain or loss on the disposal of the subsidiary.

All significant intercompany transactions and balances within the Group are eliminated on consolidation.

(b) Subsidiaries

Subsidiaries are those entities in which the Company, directly or indirectly, controls the composition of the board of directors, controls more than half the voting power or holds more than half of the issued share capital.

In the Company's balance sheet, the investments in subsidiaries are stated at cost less provision for impairment losses. The results of subsidiaries are accounted for by the Company on the basis of dividends received and receivables.

(c) Revenue recognition

(i) The Group's revenues are recognized as follows:

- Revenues derived from local, domestic long distance ("DLD") and international long distance ("ILD") telephone usage, which vary depending on the day, the time of day, the distance and duration of the call and the tariffs, are recognized when the services are provided to customers.

- Monthly telephone service fees are recognized in the period during which the telephone services are provided to customers.

- Upfront connection and installation fees received are deferred and recognized over the expected customer relationship period of 10 years. With effect from July 1, 2001, no further upfront fees for connection were charged to customers.

- Revenues from the sale of prepaid calling cards are deferred and recognized as the cards are consumed by customers.

- Revenues from PHS bundled service contracts are recognized as local, DLD, or ILD service fees according to the type of usage and on a systematic basis to match the pattern of usage of the PHS services by customers. PHS bundled service contracts comprise the provision of PHS services and handsets to customers, under which customers either prepay a certain amount of service fee or commit to spend a minimum monthly service fee for a designated period in order to receive a free handset (see Note 4(r)(ii) for the policy on accounting for the cost of the handset).

- Revenues from value-added communication services such as call waiting, call diverting and caller number display are recognized when the services are provided to customers.

4 Principal accounting policies *(continued)*

(c) Revenue recognition *(continued)*

(i) The Group's revenues are recognized as follows: (continued)

- Revenues from the provision of broadband and other Internet-related services and managed data services are recognized when the services are provided to customers.

- Revenue from information communication technologies services are recognized when goods are delivered to the customer (which generally coincides with the time when the customer has accepted the goods and the related risks and rewards of ownership have been transferred to the customer) or when services are rendered to customer.

- Interconnection fees from domestic and foreign telecommunications operators are recognized when the services are rendered as measured by the minutes of traffic processed.

- Lease income from the leasing of lines and customer-end equipment is recognized over the term of the lease. Lease income from other domestic telecommunications operators and business customers for the usage of the Group's fixed line telecommunications networks is measured by the number of lines leased and the agreed upon rate per line leased. The lease arrangements are primarily determined on a year to year basis.

(ii) Interest income

Interest income is recognized on a time proportion basis, taking into account the principal amounts outstanding and the interest rates applicable.

(iii) Dividend income

Dividend income is recognized when the right to receive payment is established.

(d) Interest expenses

Interest expenses attributable to the acquisition, construction or production of an asset that necessarily takes a substantial period of time to get ready for its intended use or sale are capitalized as part of the cost of that asset.

All other interest expenses are charged to the consolidated income statement in the year in which they are incurred.

(e) Interconnection charges

Interconnection charges represent amounts incurred for the use of other telecommunications operators' networks for facilitating the completion of calls that originate from the Group's fixed line telecommunications networks. Interconnection charges are recognized on an accrual basis. Interconnection charges with domestic operators and the fellow subsidiaries of the Group are accrued based on actual amounts, while those with overseas operators are accrued based on the actual amounts, if known, or the Group's estimates.

4 Principal accounting policies *(continued)*

(f) Translation of foreign currencies

(i) Functional and presentation currency

Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates ("the functional currency").

(ii) Transactions and balances

Transactions in foreign currencies are translated at exchange rates ruling at the transaction dates. Monetary assets and liabilities expressed in foreign currencies at the balance sheet dates are translated at rates of exchange ruling at the balance sheet dates. Exchange differences arising in these cases are dealt with in the consolidated income statements

(iii) The Group

The results and financial position of all the group entities that have a functional currency different from the presentation currency are translated into the presentation currency as follows:

- Assets and liabilities for each balance sheet presented are translated at the closing rate at the date of that balance sheet;
- Income and expenses for each income statement are translated at average exchange rates (unless this average is not a reasonable approximation of the cumulative effect of the rates prevailing on the transaction dates, in which case income and expenses are translated at the dates of the transactions); and
- All resulting exchange differences are recognized as a separate component of equity.

On consolidation, exchange differences arising from the translation of the net investment in foreign entities, and of borrowings and other currency instruments designated as hedges of such investments, are taken to shareholders' equity. When a foreign operation is sold, such exchange differences are recognized in the income statement as part of the gain or loss on disposal.

(g) Cash and cash equivalents

Cash and cash equivalents, comprising cash on hand, deposits held at call with banks and cash investments with original maturities of three months or less are carried at cost.

(h) Accounts receivable and other receivables

Accounts and other receivables are recognized initially at fair value and subsequently measured at amortized cost using the effective interest method, less provision for impairment. A provision for impairment of accounts and other receivables is established when there is objective evidence that the Group will not be able to collect all amounts due according to the original terms of receivables. The amount of the provision is the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the effective interest rate. The amount of the provision is recognized in the income statement.

4 Principal accounting policies *(continued)*

(i) Inventories and consumables

Inventories comprise mainly telephone handsets and are stated at the lower of cost and net realizable value on a first-in, first-out basis, after provisions for obsolescence. Net realizable value is the estimated selling price in the ordinary course of business, less applicable variable selling expenses.

Consumables consist of materials and supplies used in maintaining the Group's telecommunication networks and are charged to the income statement when brought into use. Consumables are valued at cost less any provision for obsolescence.

(j) Lease prepayments

(i) Lease prepayments for land

Lease prepayments for land represent payments for land use rights. Lease prepayments for land are stated at cost initially and expensed on a straight line basis over the lease period.

(ii) Lease prepayments for network capacity

Lease prepayments for network capacity represent payments for network capacity on an indefeasible right of use basis for the own use of the Company. Lease prepayments for network capacity are stated at cost initially and expensed on a straight line basis over the lease period.

(k) Fixed assets

(i) Construction-in-progress

Construction-in-progress represents buildings, telecommunications networks plant, transmission and switching equipment under construction and pending installation, and is stated at cost less impairment losses. Cost comprises direct costs of construction including borrowing costs attributable to the construction during the period of construction. When the asset being constructed becomes ready for use, the construction-in-progress is transferred to the appropriate category of fixed assets.

(ii) Other fixed assets

Fixed assets are initially stated at cost less accumulated depreciation and accumulated impairment losses. Historical cost includes expenditure that is directly attributable to the acquisition of the items. The subsequent costs are included in the assets' carrying amount or recognized as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably. Any other costs incurred in restoring fixed assets are charged to the income statement as incurred.

Buildings subsequent to initial recognition are stated at cost less accumulated impairment losses and depreciated over their expected useful lives.

4 Principal accounting policies *(continued)*

(k) Fixed assets *(continued)*

(iii) Revaluations

Fixed assets other than buildings are carried at their revalued amounts. Revalued assets are stated at fair value as of the revaluation date less accumulated depreciation. When an item of fixed asset is revalued, any accumulated depreciation at the date of the revaluation is restated proportionately together with the change in the gross carrying amount of the asset so that the carrying amount of the asset after revaluation equals its revalued amount.

Increases in valuation are credited to the revaluation reserve. Decreases in valuation are first set off against any revaluation surplus on earlier valuations in respect of the same item and thereafter are debited to operating profit. Any subsequent increases are credited to operating profit up to the amount previously debited. Each year the difference between depreciation based on the revalued carrying amount of the asset expensed in the income statement and depreciation based on the asset's original cost is transferred from the revaluation reserve to retained earnings.

Revaluations on fixed assets will be performed with sufficient regularity by independent valuers and in each of the intervening years valuations will be undertaken by executives of the Group.

(iv) Depreciation

Fixed assets are depreciated at rates sufficient to write off their costs or revalued amounts less accumulated impairment losses and estimated residual values over their estimated useful lives on a straight-line basis. The principal useful lives are as follows:

Buildings	8-30 years
Telecommunications networks and equipment	5-10 years
Furniture, fixture, motor vehicles and other equipment	5-10 years

The useful lives and estimated residual values are reviewed and modified periodically at every balance sheet date.

(v) Gain or loss on sale of fixed assets

The gain or loss on disposal of a fixed asset is the difference between the net sales proceeds and the carrying amount of the relevant asset, and is recognized in the income statement, except where the fixed asset is carried at valuation. The relevant portion of the revaluation reserve realized in respect of previous valuations is transferred to retained earnings and is shown as a movement in reserves.

(l) Impairment of assets

Assets that are subject to amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognized for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. For the purpose of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating units).

4 Principal accounting policies *(continued)*

(m) Assets held under leases

(i) Finance leases

Leases of assets where the Group has substantially all the risks and rewards of ownership are classified as finance leases. Finance leases are capitalized upon commencement of the lease at the lower of the fair value of the leased assets and the present value of the minimum lease payments. Each lease payment is allocated between the liability and finance charges so as to achieve a constant rate on the finance leases balance outstanding. The corresponding rental obligations, net of finance charges, are included in current and non-current borrowings. The interest element of the finance cost is recognized in the income statement over the lease period so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period.

(ii) Operating leases

Leases in which a significant portion of the risks and rewards of ownership are retained by the lesser are classified as operating leases. Payments made under operating leases (net of any incentives received from the lesser) are expensed in the income statement on straight-line basis over the period of the lease.

(n) Intangible assets

(i) Purchased software

Expenditure on purchased software is capitalized and amortized using the straight-line method over the expected useful lives of the software, which vary from two to five years.

(ii) Sponsorship fee

The sponsorship fee for the 2008 Beijing Olympic Games has been capitalized and amortized on a straight-line basis over 4 years, being the estimated beneficial period under the sponsorship program. The cost of the intangible asset is calculated based on the expected cash payment and the fair value of the services to be provided

(o) Provisions

Provisions are recognized when the Group has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources will be required to settle the obligation, and a reliable estimate of the amount can be made. Provisions are not recognized for operating loss arising from future periods.

Where there are a number of similar obligations, the likelihood that an outflow will be required in settlement is determined by considering the class of obligations as a whole. A provision is recognized even if the likelihood of an outflow with respect to any one item included in the same class of obligations may be small.

4 Principal accounting policies *(continued)*

(p) Employee benefits

(i) Pension obligations

(a) Employees in the PRC are entitled to retirement benefits equal to a fixed proportion of their salary at their normal retirement age which is paid by the PRC government. As stipulated by the regulations of the PRC, the subsidiaries in the PRC make contributions to the basic defined contribution pension plans organized by their respective municipal governments under which they are governed. The Group is required to make such contributions to these plans at a rate of 20% of the salaries, bonuses and certain allowances of the employees. The Group has no other material obligation for post-retirement benefits beyond these payments as they fall due. Payments made under these plans are expensed as incurred.

(b) The Group also operates a mandatory provident fund scheme ("the MPF scheme") under the Hong Kong Mandatory Provident Fund Schemes Ordinance for employees employed under the jurisdiction of the Hong Kong Employment Ordinance. The MPF scheme is a defined contribution retirement scheme administered by independent trustees. Under the MPF scheme, the employer and its employees are each required to make contributions to the scheme at 5 percent of the employees' relevant income, subject to a cap of monthly relevant income of HK$20,000.

(ii) Early retirement benefits

Early retirement benefits are recognized as expenses when the Group reaches agreement with the relevant employees for early retirement.

(iii) Employee housing benefits

One-off cash housing subsidies paid to PRC employees are charged to the consolidated income statements in the year in which it is determined that the payment of such subsidies is probable and the amounts can be reasonably estimated (see Note 32).

PRC full-time employees of the Group participate in various government-sponsored housing funds. The Group contributes on a monthly basis to these funds based on certain percentages of the salaries of the employees. The Group's liability in respect of these funds is limited to the contributions payable in each period. Contributions to these housing funds are expensed as incurred.

(iv) Share option scheme

The Group operates an equity-settled, share-based compensation plan. The fair value of the employee services received in exchange for the grant of the options is recognized as an expense. The total amount to be expensed over the vesting period is determined by reference to the fair value of the options granted, excluding the impact of any non-market vesting conditions (for example, profitability and sales growth targets). Non-market vesting conditions are included in assumptions about the number of options that are expected to become exercisable. At each balance sheet date, the entity revises its estimates of the number of options that are expected to become exercisable. It recognizes the impact of the revision of original estimates, if any, in the income statement, and a corresponding adjustment to equity over the remaining vesting period.

(q) Deferred taxation

Deferred taxation is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements. Taxation rates enacted or substantially enacted at the balance sheet date are used to determine deferred taxation. Deferred tax assets are recognized to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilized.

4 Principal accounting policies *(continued)*

(r) Other non-current assets

(i) Deferred installation costs

The direct incremental costs associated with the installation of fixed line services are deferred and expensed to the income statement over the expected customer relationship period of 10 years except when the direct incremental costs exceed the corresponding upfront installation fees. In such cases, the excess of the direct incremental costs over the installation fees are recorded immediately as expenses in the income statement.

(ii) Subscriber acquisition costs

The cost of handsets given to customers under bundled service contracts are deferred as subscriber acquisition costs and expensed to the income statement on a systematic basis to match with the pattern of the customer service income over the contract period.

(iii) Prepaid network capacities

Prepayments for the network capacities purchased on an indefeasible rights to use (''IRU'') basis for resale are capitalized and expensed over the corresponding lease period.

(s) Derivative financial instruments

Derivative financial instruments are stated at fair value on the balance sheet. Realized and unrealized gains and loses arising from change in the fair value are included in the income statement in the period in which they arise.

(t) Discontinued operation

A discontinued operation is a component of the Group that may be a major line of business or geographical area of operations that has been disposed or is held for sale. The result of that component is separately reported as "discontinued operations" in the income statement. The comparative income statement is restated as if the operation had been discontinued from the start of the comparative period. The assets, liabilities and minority interests of such component classified as "discontinued operations" or "held for sale" is presented separately in the assets, liabilities and minority sections, respectively, of the consolidated Balance Sheet.

4 Principal accounting policies *(continued)*

(u) Contingent liabilities

A contingent liability is a possible obligation that arises from past events and whose existence will only be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the Group. It can also be a present obligation arising from past events that is not recognized because it is not probable that outflow of economic resources will be required or the amount of obligation cannot be measured reliably.

A contingent liability is not recognized but is disclosed in the notes to the financial statements when an outflow of economic benefits is less than probable but not remote. When a change in the probability of an outflow occurs such that the outflow is probable, the contingent liability will then be recognized as a provision.

A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain events not wholly within the control of the Group. A contingent asset is disclosed when an inflow of economic benefits is probable but only recognized in income statement when realized.

(v) Segmental reporting

Business segments provide services that are subject to risks and returns that are different from other business segments. Geographical segments provide services within a particular economic environment that is subject to risks and returns that differ from those of components operating in other economic environments. Currently the Group has one business segment, the provision of fixed line telecommunications services. Less than 10% of the Group's assets and operations are located outside the PRC. Accordingly, no business and geographical segment information is presented.

(w) Earnings per share ("EPS") and per American Depository Shares ("ADS")

Basic EPS is computed by dividing net profit attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the year.

Diluted EPS is computed by dividing net profit attributable to shareholders by the weighted average number of ordinary and dilutive ordinary equivalent shares outstanding during the year. Dilutive ordinary equivalent shares consist of ordinary shares issuable upon the exercise of outstanding stock options using the treasury stock method.

Earnings per ADS is computed by multiplying the EPS by 20, which is the number of shares represented by each ADS.

5 Critical accounting estimates and judgments

Estimates and judgments are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under circumstances.

(a) Critical accounting estimates and assumptions

The Group makes estimates and assumptions concerning the future. The resulting accounting estimates will, by definition, seldom equal the related actual results. The estimates and assumptions that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are discussed below:

(i) Depreciation of property, plant and equipment

The property, plant and equipment of the Group are depreciated at rates sufficient to write off their costs or revalued amounts less accumulated impairment losses and estimated residual values over their estimated useful lives on a straight-line basis. The Group reviews the useful lives periodically to ensure that the method and rates of depreciation are consistent with the expected pattern of economic benefits from property, plant and equipment. The Group estimates the useful lives of the property, plant and equipment as set out in Note 4(k)(iv) based on the historical experience with similar assets, taking into account anticipated technological changes. The depreciation expenses in the future periods will change if there are significant changes from previous estimates.

(ii) Revaluation of property, plant and equipment

Apart from buildings and lease prepayments for land which are carried at cost, other property, plant and equipment are carried at revalued amounts, being the fair value at the date of revaluation, less subsequent accumulated depreciation and impairment. Property, plant and equipment of the Group was revalued as of December 31, 2006 on a depreciated replacement cost basis by an independent valuer. If the revalued amounts differ significantly from the carrying amounts of the property, plant and equipment in the future, the carrying amounts will be adjusted to the revalued amounts. The key assumptions made to determine the revalued amounts include the estimated replacement costs and the estimated useful lives of the property, plant and equipment. This will have an impact on the Group's future results, since any subsequent decreases in valuation are set off first against increases on earlier valuations in respect of the same item and thereafter are charged as an expense to the income statement and any subsequent increases are credited as income to the income statement up to the amount previously charged then to equity. In addition, the depreciation expense in future periods will change as the carrying amounts of such property, plant and equipment change as a result of the revaluation.

(iii) Impairment of non-current assets

At each balance sheet date, the Group considers both internal and external sources of information to assess whether there is any indication that non-current assets, including property, plant and equipment, are impaired. If any such indication exists, the recoverable amount of the assets is estimated and an impairment loss is recognized to reduce the carrying amount of the assets to its recoverable amount. The recoverable amount is the higher of value in use or net selling price. Estimated values in use are determined based on estimated discounted future cash flows of the cash generating unit at the lowest level to which the asset belongs. Key assumptions made to determine the estimated discounted future cash flows include the estimated future cash flow, estimated growth rate and the estimated weighted average cost of capital of the Group. Such impairment losses are recognized in the income statement, except where the asset is carried at valuation and the impairment loss does not exceed the revaluation surplus for that same asset, in which case the impairment loss is treated as a revaluation decrease and charged to the revaluation reserve, Accordingly, there will be an impact to the future results if there is a significant change in the recoverable amounts of the non-current assets.

5 Critical accounting estimates and judgments *(continued)*

(a) Critical accounting estimates and assumptions *(continued)*

(iv) Revenue recognized for upfront connection and installation fees

The Group defers the recognition of upfront customer connection and installation fees and amortizes them over the expected customer relationship period of 10 years. The related direct incremental installation costs are deferred and amortized over the same expected customer relationship period of 10 years, except when the direct incremental costs exceed the corresponding installation fees, the excess amounts are immediately written off as an expense to the income statement. The Group estimates the expected customer relationship period based on the historical customer retention experience and after factoring in the expected level of future competition, the risk of technological or functional obsolescence to the Group's services, technological innovation, and the expected changes in the regulatory and social environment. If the Group's estimate of the expected customer relationship period changes as a result of increased competition, changes in telecommunications technology or other factors, the amount and timing of recognition of the deferred revenues may change for future periods.

(v) Provision for doubtful debts

The Group maintains an allowance for doubtful debts for estimated losses resulting from the inability of its customers to make the required payments. The Group makes its estimates based on the aging of its accounts receivable balances, customer's creditworthiness, and historical write-off experience. If the financial condition of its customers were to deteriorate, actual write-offs might be higher than expected, and the Group would be required to revise the basis of making the allowance and its future results would be affected.

(vi) Fair value

The Group estimates the fair value of its financial assets and financial liabilities including accounts receivable, prepayments, other receivables and other current assets, accounts payable, and bank and other loans for disclosure purposes by discounting its future contractual cash flows at the estimated current market interest rate that is available to the Group for similar financial instruments. The future disclosed values will change if there are changes in the estimated market interest rate.

(b) Critical judgments in applying the entity's accounting policies

(i) Accounting for business combinations under common control

The Group completed the Acquisition of New Horizon on October 31, 2005. The Acquisition of New Horizon is a business combination under common control. The Group adopted merger accounting to account for the business combination under common control as the Group believes that the financial statements prepared under merger accounting are more relevant to those transactions.

(ii) Recognition of revenues and costs under PHS bundled service contracts

The Group provides PHS services, which is an extension of the local wireline telecommunications services, to customers. Promotional packages comprise the bundled provision of PHS services and handsets to customers, under which customers either prepay a certain amount of service fee or commit to spend a minimum monthly service fee for a designated period of time in order to receive a free handset. The total revenues received or receivable are recognized as deferred revenue. The cost of handsets provided to customers is treated as deferred customer acquisition costs, to the extent that they are recoverable through profits made from future service fees. Such deferred revenue and deferred costs are amortized to the income statement on a systematic basis to match the shorter of the pattern of usage of the related service and the minimum non-cancelable contract period. If the pattern of the usage of the PHS services by the customer changes in the future, the amortization period of the revenue and costs will change accordingly, which will have an impact on future results.

6 Financial risk management

(a) Financial risk factors

The Group's activities expose it to a variety of financial risks: market risk (including currency risk, cash flow interest rate risk, and fair value interest-rate risk), credit risk and liquidity risk.

(i) Foreign exchange risk

As at December 31, 2006 and 2005, the Group had foreign currency denominated bank balances amounting to RMB1,946 million and RMB1,098 million respectively. As at December 31, 2006 and 2005, the Group had foreign currency denominated bank loans amounting to RMB1,432 million and RMB1,998 million respectively.

(ii) Cash flow and fair value interest rate risk

The Group is exposed to changes in interest due to its long-term debt obligation. The Group enters into debt obligations to support general corporate operations including capital expenditures, acquisitions, and working capital needs. Borrowings at variable interest rates expose the Group to cash flow interest rate risk. Borrowings issued at fixed interest rates expose the Group to fair value interest rate risk. The bank loans issued at variable and fixed interest rates are disclosed in Note 29 of these financial statements.

(iii) Credit risk

The carrying amount of accounts receivable included in the balance sheet represents the Group's exposure to credit risk in relation to its financial assets. The Group's receivables are unsecured to the extent they are not covered by security deposits. The Group believes that adequate provision for uncollectible account receivable has been made.

(iv) Liquidity risk

A significant percentage of the Group's funding requirements is achieved through short term borrowings, and the balance sheet indicates a significant working capital deficit. Please refer to Note 2 for the details.

(b) Fair value estimation

The fair value of financial instruments traded in active markets is based on quoted market prices at the balance sheet date. The quoted market price used for financial assets held by the Group is the current bid price; the appropriate quoted market price for financial liabilities is the current ask price.

The carrying value less estimated credit adjustments of trade receivables and payables are assumed to approximate their fair values. The fair value of financial liabilities for disclosure purposes is estimated by discounting the future contractual cash flows at the current market interest rate that is available to the Group for similar financial instruments.

7 Revenues

Revenues represent the turnover of the Group and are derived from the provision of fixed line telecommunications and related services, net of the PRC business taxes and government levies. The Group's revenues by business nature can be summarized as follows:

	Year ended December 31	
	2006	2005
	RMB million	RMB million Restated Note 2
Revenues		
Local usage fees	**22,274**	24,582
Monthly telephone services	**16,689**	18,261
Upfront installation fees	**1,369**	1,442
DLD usage fees	**10,185**	10,260
ILD usage fees	**1,160**	1,180
Value-added services	**5,421**	4,000
Interconnection fees	**8,400**	7,783
Upfront connection fees	**2,406**	3,405
Broadband services	**10,556**	7,824
Other Internet-related services	**692**	591
Managed data services	**1,505**	1,656
Leased line income	**2,974**	2,596
Information communication technologies services	**788**	—
Other services	**2,502**	2,281
Total	86,921	85,861

Notes to the Consolidated Financial Statements

8 Operating expenses by nature

Operating expenses mainly represent:

	Year ended December 31	
	2006	2005
	RMB million	RMB million Restated Note 2
Staff cost	**12,151**	12,034
Depreciation and amortization	**25,608**	24,919
Maintenance cost	**4,688**	4,689
Miscellaneous taxes and fees	**282**	252
Customer installation cost	**1,161**	1,157
Interconnection charges	**4,332**	3,487
Advertising and promotion expenses	**933**	926
Sales channel cost	**2,643**	2,304
Subscriber acquisition and retention cost	**3,686**	4,308
Auditor's remuneration	**61**	34
Bad and doubtful debt expenses	**1,009**	1,144
Operating leases	**2,208**	2,109

9 Finance costs

	Year ended December 31	
	2006	2005
	RMB million	RMB million Restated Note 2
Interest expenses on:		
- Bank and other loans wholly repayable within five years	3,305	3,589
-Bank and other loans wholly repayable after more than five years	325	177
-Deferred consideration related to Acquisition of New Horizon	479	87
	4,109	3,853
Less: Interest expenses capitalized in construction in progress	(233)	(297)
	3,876	3,556
Exchange gain, net	(8)	(229)
Bank charges	20	20
	3,888	3,347
Interest expenses were capitalized in construction in progress using the following annual interest rates	4.71%-5.28%	4.17%-4.97%

10 Taxation

	Year ended December 31	
	2006	2005
	RMB million	RMB million Restated Note 2
PRC enterprise income tax ("EIT")	**4,039**	3,581
Overseas profit tax	**20**	11
Deferred taxation (Note 33)	**(500)**	(162)
Taxation charges	**3,559**	3,430

The provision for PRC EIT is calculated based on the statutory income tax rate of 33% on the assessable profit of each of the entities now comprising the Group in the PRC as determined in accordance with the relevant income tax rules and regulations in the PRC.

Taxation on profits derived from certain subsidiaries outside the PRC, including Hong Kong, has been calculated on the estimated assessable profit at the rates of taxation ranging from 17.50% to 34.00%, prevailing in the countries in which those entities operate.

The reconciliation between the Group's actual tax charge and the amount which is calculated based on the weighted average statutory tax rate is as follows:

	Year ended December 31	
	2006	2005
	RMB million	RMB million Restated Note 2
Profit before taxation	**14,700**	17,544
Weighted average statutory tax rate	**33%**	33%
Tax calculated at the weighted average statutory tax rate	**4,851**	5,790
Non-taxable income (Note (a) below)	**(1,216)**	(1,499)
Utilization of tax losses not recognized in previous years (Note (b) below)	**—**	(837)
Expenses not deductible for tax purposes	**64**	69
Tax losses not recognized	**26**	55
Others	**(166)**	(148)
Tax charge	**3,559**	3,430

Note (a) Non-taxable income comprises primarily upfront connection fees charged to customers which are amortized over the customer relationship.

Note (b) Prior to 2005, a deferred tax asset arising from certain tax losses was not recognized as it was uncertain at that time, following the change of a subsidiary's tax registration district, that the taxable loss could be utilized at the previous period end date.

11 Profit attributable to shareholders

(a) For the year ended December 31, 2006, profit attributable to shareholders includes current year profit of RMB17,475 million (2005: RMB126 million), which has been recognized in the financial statements of the Company.

(b) The Company's subsidiary, CNC China is registered as a foreign investment enterprise in the PRC. In accordance with the Articles and Association of CNC China, it is required to provide for certain statutory reserves, namely, general reserve and staff bonus and welfare fund, which are appropriated from profits after tax but before any dividend distribution.

CNC China is required to allocate at least 10% of their profit after tax determined under PRC GAAP to the general reserve fund until the cumulative amounts reach 50% of the registered capital. The statutory reserve can only be used, upon obtaining approval from the relevant authority, to offset accumulated losses or increase capital.

Accordingly, CNC China appropriated approximately RMB855 million to the general reserve fund for the year ended December 31, 2006 (2005: RMB1, 044 million).

(c) According to a PRC tax approval document issued by the Ministry of Finance and State Administration of Taxation to the Group, the Group's upfront connection fees are not subject to EIT and an amount equal to the upfront connection fees recognized in the retained earnings should be transferred from retained earnings to a statutory reserve. For the year ended December 31, 2006, the Company has made an appropriation of RMB9,189 million to the statutory reserve (2005 : RMB6,783 million).

12 Profit distributions

	Year ended December 31			
	2006		2005	
	HK$ million	**RMB million**	HK$ million	RMB million
Final dividend proposed after balance sheet date of HK$0.553 per share (2005 : HK$0.466 per share)	**3,678**	**3,695**	3,073	3,196
Dividend distributed during the year	**3,073**	**3,196**	245	259

In the meeting of the board of directors held on April 2, 2007, the directors proposed a final dividend of HK$0.553 per ordinary share for the year ended December 31, 2006. Dividends proposed after the balance sheet date have not been reflected as a dividend payable and will be reflected as an appropriation in the 2007 financial statements.

13 Earnings per share

Basic earnings per share is computed using the weighted average number of ordinary shares outstanding during the year. Diluted earnings per share is computed using the weighted average number of ordinary shares and potential ordinary shares outstanding during the year.

The following table sets forth the computation of basic and diluted earnings per share:

	Year ended December 31	
	2006	2005
	in RMB million, except share and per share data	
		Restated Note 2
Numerator:		
Profit/ (loss) for the year		
- Continuing operations	**11,141**	14,114
- Discontinued operations	**1,819**	(226)
	12,960	13,888
Denominator:		
Weighted average number of ordinary shares outstanding and shares used in computing basic earnings per share	**6,615,520,381**	6,593,529,000
Diluted equivalent shares arising from share options	**51,955,496**	34,112,723
Shares used in computing diluted earnings per share	**6,667,475,877**	6,627,641,723
Basic earnings/(loss) per share (RMB)		
- Continuing operations	**1.68**	2.14
- Discontinued operations	**0.27**	(0.03)
- Profit for the year	**1.95**	2.11
Diluted earnings/(loss) per share (RMB)		
- Continuing operations	**1.67**	2.13
- Discontinued operations	**0.27**	(0.03)
- Profit for the year	**1.94**	2.10

14 Staff cost including directors' remuneration

	Year ended December 31	
	2006	2005
	RMB million	RMB million Restated Note 2
Wages, salaries and welfare	**10,792**	10,747
Contributions to pensions	**1,359**	1,285
Early retirement benefits	**—**	2
Total	**12,151**	12,034

15 Directors' and senior management's emoluments

(a) Directors' emoluments

The following table set out the emoluments paid to the Company's directors during the year of 2006:

	Year ended December 31, 2006 RMB thousand					
Directors' name	**Fees(a)**	**Basic salaries, housing allowances, other allowances and benefits in kind**	**Subtotal**	**Share based compensation**	**Contributions to retirement schemes**	**Total**
Zhang Chunjiang	—	763	763	312	19	1,094
Zuo Xunsheng (i)	—	746	746	272	19	1,037
Zhang Xiaotie	—	671	671	272	19	962
Li Fushen (ii)	—	671	671	272	19	962
Miao Jianhua	—	671	671	238	19	928
Jiang Weiping (iii)	—	453	453	238	19	710
Li Liming (iv)	—	420	420	238	19	677
Tian Suning (v)	—	—	—	312	—	312
Yan Yixun	251	—	251	200	—	451
John Lawson Thornton	409	—	409	—	—	409
Victor Cha Mou Zing	453	—	453	—	—	453
Qian Yingyi	545	—	545	—	—	545
Hou Ziqiang	483	—	483	—	—	483
Timpson Chung Shui Ming	460	—	460	—	—	460
José María Álvarez-Pallete	317	—	317	—	—	317
Mauricio Sartorius (vi)	9	—	9	—	—	9
Total	2,927	4,395	7,322	2,354	133	9,809

The fees disclosed above include RMB2,350 thousand paid to independent non-executive directors.

15 Directors' and senior management's emoluments *(continued)*

(a) Directors' emoluments *(continued)*

The following table set out the emoluments paid to the Company's directors during the year ended December 31, 2005:

	Year ended December 31, 2005 RMB thousand						
Directors' name	Fees (a)	Basic salaries, housing allowances, other allowances and benefits in kind	Fees waived (a)	Subtotal	Share based compensation	Contributions to retirement schemes	Total
Zhang Chunjiang	261	1,077	(261)	1,077	564	16	1,657
Tian Suning	261	1,244	(261)	1,244	564	—	1,808
Zhang Xiaotie	261	396	(261)	396	490	16	902
Miao Jianhua	261	622	(261)	622	429	16	1,067
Jiang Weiping	309	611	(309)	611	429	16	1,056
Li Liming	313	565	(313)	565	429	16	1,010
Keith Rupert Murdoch(vii)	219	—	—	219	362	—	581
Yan Yixun	261	—	—	261	362	—	623
John Lawson Thornton	365	—	—	365	—	—	365
Victor Cha Mou Zing	361	—	—	361	—	—	361
Qian Yingyi	417	—	—	417	—	—	417
Hou Ziqiang	413	—	—	413	—	—	413
Timpson Chung Shui Ming	333	—	—	333	—	—	333
José María Álvarez-Pallete (viii)	95	—	—	95	—	—	95
Total	4,130	4,515	(1,666)	6,979	3,629	80	10,688

The fees disclosed above include RMB1,889 thousand paid to independent non-executive directors.

15 Directors' and senior management's emoluments *(continued)*

(a) Directors' emoluments *(continued)*

Note:

(a) On December 6, 2006, according to the directors' discretion, Zhang Chunjiang, Zuo Xunsheng ,Zhang Xiaotie, Miao Jianhua, Jiang Weiping, Li Liming and Tian Suning waived their emoluments for the years ended December 31 2006 and 2005 totalling RMB1,526 thousand and 1,666 thousand respectively. Details of the waivers are as follows: Zhang Chunjiang RMB251 thousand (2005: RMB261 thousand), Zuo Xunsheng RMB158 thousand (2005: Nil), Zhang Xiaotie RMB251 thousand (2005: RMB261 thousand), Miao Jianhua RMB251 thousand (2005: RMB261 thousand), Jiang Weiping RMB94 thousand (2005: RMB309 thousand), Li Liming RMB270 thousand (2005: RMB313 thousand), Tian Suning RMB251 thousand (2005: RMB261 thousand).

(i) Appointed in May 2006
(ii) Appointed in January 2007
(iii) Resigned in May 2006
(iv) Resigned in January 2007
(v) Re-designated as non-executive Directors in May 2006
(vi) Appointed in December 2006
(vii) Resigned in September 2005.
(viii) Appointed in September 2005.

(b) Five highest paid individuals

The five individuals whose emoluments were the highest for the year ended December 31, 2006 includes 2 directors (2005: 2) whose emoluments are reflected in the analysis presented above. The emoluments payable to the remaining individuals are as follows:

	Year ended December 31	
	2006	2005
	RMB thousand	RMB thousand
Basic salaries, housing allowances, other allowances and benefits in kind	**2,013**	4,458
Share based compensation	**816**	1,471
Contributions to retirement schemes	**57**	33
Total	**2,886**	5,962

The number of the remaining individuals whose emoluments fell within the following bands is set out as follows:

	Year ended December 31	
	2006	2005
Nil - RMB1,004,700 (equivalent of Nil - HK$ 1,000,000)	**3**	—
RMB1,004,701 - RMB1,507,050 (equivalent of HK$1,000,001 - HK$1,500,000)	**—**	2
RMB1,507,051 - RMB2,009,400 (equivalent of HK$1,500,001 - HK$2,000,000)	**—**	—
RMB2,009,401 - RMB2,511,750 (equivalent of HK$2,000,001 - HK$2,500,000)	**—**	—
RMB2,511,751 - RMB3,014,100 (equivalent of HK$2,500,001 - HK$3,000,000)	**—**	1

16 Cash and bank deposits

	Group		Company	
	As at December 31		As at December 31	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
Cash and cash equivalents	**7,569**	4,874	**1,772**	540
Time deposits with original maturities over three months	**2**	21	**—**	—
Total cash and bank deposits	**7,571**	4,895	**1,772**	540
Effective interest rate of time deposits with original maturities over three months (% per annum)	**0.72**	0.72	**—**	—

Included in cash and bank deposits as of December 31, 2006 and 2005 are RMB denominated balances kept in the PRC amounting to RMB5,625 million and RMB3,797 million respectively. The conversion of RMB denominated balances into foreign currencies and the remittance of bank balances and cash out of the PRC are subject to the rules and regulation of foreign exchange control promulgated by the PRC government.

Included in the bank deposits were deposits in state-owned banks amounting to RMB7,422 million at December 31, 2006 (2005: RMB4,791 million). For the year ended December 31, 2006, interest income earned from these state-owned banks deposits amounted to RMB121 million (2005 : RMB124 million).

17 Accounts receivable

Amounts due from the provision of fixed line telecommunications services to residential and business customers are due within 30 days from the date of billing. Residential customers who have accounts overdue by more than 90 days will in normal circumstances have their services disconnected. Accounts receivable from other telecommunications operations and customers are due between 30 to 90 days from the billing date.

The ageing analysis of accounts receivable based on the billing date is as follows:

	As at December 31	
	2006	2005
	RMB million	RMB million
0-30 days	**5,744**	5,446
31-90 days	**1,557**	1,556
Over 90 days	**2,326**	2,053
Total	**9,627**	9,055
Less: Allowance for doubtful debts	**(1,344)**	(1,654)
Net carrying amounts	**8,283**	7,401

The movement of allowance for doubtful debts is as follows:

	As at December 31	
	2006	2005
	RMB million	RMB million
Balance at beginning of year	**1,654**	1,412
Additional provisions	**1,002**	1,169
Less: Write-offs	**(1,246)**	(927)
Disposal of ANC Group	**(66)**	—
Balance at end of year	**1,344**	1,654

The carrying value of accounts receivable approximates their fair values based on cash flows discounted using a rate based on the average short-term borrowing rate of 6.12% (December 31, 2005: 5.58%).

Included in the accounts receivable are amounts due from other state-owned telecommunication operators amounting to RMB1,079 million on December 31, 2006. (December 31, 2005: RMB1,003 million).

18 Inventories and consumables

	As at December 31	
	2006	2005
	RMB million	RMB million
Telephone handsets and other customer end-products held for resale, at cost	**155**	144
Consumables, at cost	**261**	328
Total	**416**	472

19 Prepayments, other receivables and other current assets

	Group		Company	
	As at December 31		As at December 31	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
Prepaid expenses, deposits and other current assets	**808**	999	**15**	15
Other receivables	**629**	485	**253**	12
Total	**1,437**	1,484	**268**	27

Included in the other current assets is deferred subscriber acquisition costs of RMB274 million (2005: RMB324 million).

The carrying value of prepayments and other receivables approximates their fair values based on cash flows discounted using a rate based on the average short-term borrowing rate of 6.12% (2005: 5.58%).

Notes to the Consolidated Financial Statements

20 Fixed assets

	Buildings	Telecommunications networks and equipment	Furniture, fixture, motor vehicles and other equipment	Total
	RMB million	RMB million	RMB million	RMB million
Cost/valuation:				
Balance at January 1, 2005	25,967	264,383	13,788	304,138
Reclassifications	818	(4,981)	4,163	—
Additions	413	975	490	1,878
Transferred from construction in progress	1,659	23,106	2,053	26,818
Disposals/write off	(48)	(1,940)	(541)	(2,529)
Distributed to owner upon reorganization for the Acquisition of New Horizon	(1,759)	(1,242)	(183)	(3,184)
Balance at December 31, 2005	27,050	280,301	19,770	327,121
Accumulated depreciation:				
Balance at January 1, 2005	(5,382)	(124,673)	(7,186)	(137,241)
Reclassifications	(354)	1,170	(816)	—
Charge for the year	(956)	(21,541)	(2,157)	(24,654)
Disposals/write off	4	1,662	451	2,117
Distributed to owner upon reorganization for the Acquisition of New Horizon	487	743	90	1,320
Balance at December 31, 2005	(6,201)	(142,639)	(9,618)	(158,458)
Net book value at December 31, 2005	20,849	137,662	10,152	168,663
Net book value at January 1, 2005	20,585	139,710	6,602	166,897

20 Fixed assets *(continued)*

	Buildings	Telecommunications networks and equipment	Furniture, fixture, motor vehicles and other equipment	Total
	RMB million	RMB million	RMB million	RMB million
Cost/valuation:				
Balance at January 1, 2006	27,050	280,301	19,770	327,121
Additions	52	755	635	1,442
Transferred from construction in progress	688	21,449	2,621	24,758
Disposals/write off	(5)	(1,947)	(543)	(2,495)
Disposal of ANC Group	(172)	(636)	(45)	(853)
Fixed assets revaluation deficit, net	—	(10,659)	(3,588)	(14,247)
Balance at December 31, 2006	27,613	289,263	18,850	335,726
Accumulated depreciation:				
Balance at January 1, 2006	(6,201)	(142,639)	(9,618)	(158,458)
Depreciation charge for the year	(995)	(21,842)	(2,282)	(25,119)
Disposals/write off	3	1,315	443	1,761
Disposal of ANC Group	51	261	28	340
Fixed assets revaluation deficit, net	—	11,778	2,016	13,794
Balance at December 31, 2006,	(7,142)	(151,127)	(9,413)	(167,682)
Net book value at December 31, 2006	20,471	138,136	9,437	168,044
Net book value at January 1, 2006	20,849	137,662	10,152	168,663

20 Fixed assets *(continued)*

(a) The net book value of assets held under finance lease is as follows:

	Buildings	Telecommunications networks and equipment	Furniture, fixture, motor vehicles and other equipment	Total
	RMB million	RMB million	RMB million	RMB million
As at December 31, 2006	—	2,000	62	2,062
As at December 31, 2005	1	2,551	109	2,661

The depreciation charge on assets held under finance lease amounted to RMB351 million in the year ended December 31, 2006 (2005: RMB367 million).

(b) The analysis of the cost or revaluation of the fixed assets of the Group is as follows:

	Buildings	Telecommunications networks and equipment	Furniture, fixture, motor vehicles and other equipment	Total
	RMB million	RMB million	RMB million	RMB million
December 31, 2006				
Cost	27,613	—	—	27,613
Valuation	—	289,263	18,850	308,113
	27,613	289,263	18,850	335,726
December 31, 2005				
Cost	27,050	—	—	27,050
Valuation	—	280,301	19,770	300,071
	27,050	280,301	19,770	327,121

20 Fixed assets *(continued)*

(c) As required by the PRC rules and regulations relevant to the Listing Reorganization, each class of fixed assets other than buildings and prepayments for land as at December 31, 2003 was valued by Beijing China Enterprise Appraisal Co. Ltd. (the "PRC valuer"), an independent valuer registered in the PRC, on a depreciated replacement cost basis. The value of such assets in the PRC injected into the Group was determined at RMB122,456 million. Such revalued amounts served as the tax base of the assets with immediate effect. The surplus on revaluation of certain fixed assets of RMB2,982 million was credited to the revaluation reserve while the deficit arising from the revaluation of certain fixed assets of RMB25,778 million was recognized as an expense for the year ended December 31, 2003.

For the Listing Reorganization, valuations of buildings and the lease prepayments for land of the Group were also performed. The surplus value of such assets was determined at RMB6,967 million. Such amounts served as the tax base for such assets with immediate effect. Details have been set out in Note 33(iii).

As required by the PRC rules and regulations relevant to the Acquisition of New Horizon, each class of fixed assets, other than buildings and lease prepayments for land in the PRC, acquired as at December 31, 2004, was valued by the PRC valuer, on a depreciated replacement cost basis. The value of such acquired assets in the PRC was determined at RMB42,879 million. Such amounts served as the tax base for such assets with immediate effect. The surplus on revaluation of certain fixed assets of RMB3,863 million was credited to the revaluation reserve while the deficit arising from the revaluation of certain fixed assets of RMB11,318 million was recognized as an expense for the year ended December 31, 2004.

For the Acquisition of New Horizon, valuations of buildings and the lease prepayments for land were also performed. The surplus value of such assets was determined at RMB2,553 million. Such amounts served as the tax base for such assets with immediate effect. Details have been set out in Note 33(iii).

According to the group's accounting policies, each class of fixed assets of the Group other than buildings as at December 31, 2006 has been revalued by the PRC valuer on a depreciated replacement cost basis. The value of such fixed assets was determined at RMB147,573 million. The net deficit arising on the revaluation was RMB453 million, the net deficit was split between a credit to the revaluation reserve amounting to RMB1,071 million and an expense to the profit and loss account of RMB1,524 million for the year.

The respective carrying amounts of the telecommunication networks and equipment and furniture, fixtures, motor vehicles and other equipment would have been RMB153,368 million and RMB11,651 million as at December 31, 2006 and RMB158,193 million and RMB11,233 million as at December 31, 2005 had they been stated at cost less accumulated depreciation.

Regarding the revaluation of fixed assets carried out at December 31, 2006, the carrying amounts of these fixed assets and, where applicable, the corresponding revalued amounts of these assets are as follows:

	Historical carrying amount	**Revaluation surplus**	**Revaluation deficit**	**Revalued amount**
	RMB million	RMB million	RMB million	RMB million
At December 31, 2006				
Telecommunication networks and equipment	137,017	9,048	(7,929)	138,136
Furniture, fixtures, motor vehicles and other equipment	11,009	436	(2,008)	9,437
	148,026	9,484	(9,937)	147,573

21 Construction in progress

	As at December 31	
	2006	2005
	RMB million	RMB million
Balance at beginning of year	**6,822**	10,597
Additions	**24,863**	23,258
Transferred to fixed assets	**(24,758)**	(26,818)
Transferred to intangible assets	**(572)**	—
Distributed to owner in accordance with the Acquisition of New Horizon	**—**	(215)
Balance at end of year	**6,355**	6,822

22 Lease prepayment

	As at December 31	
	2006	2005
	RMB million	RMB million
Lease prepayments for land (i)	**2,046**	1,949
Lease prepayments for network capacity (ii)	**318**	—
	2,364	1,949

(i) Lease prepayments for land

This represents land use rights held in the PRC and their net book value is analyzed as follows:

	As at December 31	
	2006	2005
	RMB million	RMB million
Held for		
Lease of between 10 to 50 years	**2,024**	1,933
Lease of less than 10 years	**22**	16
	2,046	1,949

22 Lease prepayment *(continued)*

(i) Lease prepayments for land *(continued)*

The movement of the lease prepayments for land is as follows:

	As at December 31	
	2006	2005
	RMB million	RMB million
Balance at beginning of year	**1,949**	1,746
Additions	**165**	280
Amortization for the year	**(68)**	(37)
Distributed to owner in accordance with the Acquisition of New Horizon	**—**	(40)
Balance at end of year	**2,046**	1,949

(ii) Lease prepayments for network capacity

The net book value is analyzed as follows:

	As at December 31	
	2006	2005
	RMB million	RMB million
Held for		
Lease of between 10 to 50 years	**318**	—
Balance at end of year	**318**	—

The movement of the lease prepayments for network capacity is as follows:

	As at December 31	
	2006	2005
	RMB million	RMB million
Balance at beginning of year	**—**	—
Additions	**318**	—
Amortization for the year	**—**	—
Balance at end of year	**318**	—

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23 Intangible assets

	Negative goodwill	Purchased software	Sponsorship fees	Total
	RMB million	RMB million	RMB million	RMB million
Cost:				
Balance at January 1, 2005	3	1,250	—	1,253
Additions	—	663	540	1,203
Balance at December 31, 2005	3	1,913	540	2,456
Accumulated amortization:				
Balance at January 1, 2005	(3)	(702)	—	(705)
Amortization for the year	—	(223)	(135)	(358)
Balance at December 31, 2005	(3)	(925)	(135)	(1,063)
Net book value at January 1, 2005	—	548	—	548
Net book value at December 31, 2005	—	988	405	1,393
Cost:				
Balance at January 1, 2006	3	1,913	540	2,456
Additions	—	94	—	94
Transferred from construction in progress	—	572	—	572
Write off	(3)	(692)	—	(695)
Balance at December 31, 2006	—	1,887	540	2,427
Accumulated amortization				
Balance at January 1, 2006	(3)	(925)	(135)	(1,063)
Amortization for the year	—	(336)	(135)	(471)
Write off	3	692	—	695
Balance at December 31, 2006	—	(569)	(270)	(839)
Net book value at January,1, 2006	—	988	405	1,393
Net book value at December 31, 2006	—	1,318	270	1,588

24 Other non-current assets

	As at December 31	
	2006	2005
	RMB million	RMB million
Installation costs	**3,525**	4,197
Prepaid network capacity	**—**	1,454
Others	**441**	383
	3,966	6,034

25 Discontinued operations

On June, 2, 2006, the Group entered into an agreement with third party buyers to dispose of its entire interest in the ANC Group for an aggregate cash consideration of US$168.84 million, at fair value determined by both parties. The disposal was completed on August 22, 2006. The gain on disposal amounted to RMB1, 878 million. The results and cash flows of the ANC Group for the year ended December 31, 2006 are presented as discontinued operations.

The income statement and cash flow statement related to the ANC Group are as follows:

	Note	**For the period from January 1, 2006 to August 22, 2006**	For the year ended December 31, 2005
		RMB million	RMB million
Discontinued operations:			
Revenues		**980**	1,371
Expenses		**(1,038)**	(1,598)
Loss before taxation		**(58)**	(227)
Taxation		**(1)**	1
Loss for the period/year of discontinued operations		**(59)**	(226)
Gain on disposal of discontinued operations		**1,878**	—
Profit/(loss) for the period/year from discontinued operations		**1,819**	(226)

	Note	**For the period from January 1, 2006 to August 22, 2006**	For the year ended December 31, 2005
		RMB million	RMB million
Discontinued operations:			
Net cash inflow from operating activities		**183**	74
Cash outflow from investing activities		**(182)**	(312)
Cash inflow from disposal of ANC Group	37(c)	**1,164**	—
Net cash outflow for investing activities		**982**	(312)
Net cash inflow from financing activities		**—**	108
Cash flows from discontinued operations		**1,165**	(130)

26 Investments in subsidiaries

	Company As at December 31 2006 RMB million	2005 RMB million
Investment cost in subsidiaries	**62,937**	58,577
Due from subsidiaries (Note (b))	**9,411**	573
Due to subsidiaries (Note (c))	**(12,754)**	(12,820)
	59,594	46,330

Notes:

(a) As at December 31, 2006, the Company has direct interests in the following principal subsidiary, which is a private company:

Company name	Place and date of incorporation/ establishment	Registered capital	Percentage of equity interest attributable to the Company	Principal activities and place of operation
Directly held:				
China Netcom (Group) Company Limited (Note (i))	PRC, August 6, 1999	RMB65,308 million	100%	Provision of network communication services in the PRC

(i) The company is a wholly owned foreign enterprise established in the PRC. The accounts of the company for the years ended December 31, 2005 and 2006 were audited by PricewaterhouseCoopers Zhong Tian CPAs Limited Company.

(b) The balances are unsecured, non-interest bearing and have no fixed repayment terms.

(c) Deferred payments arising from the Acquisition of New Horizon have been transferred to CNC China at the carrying amount. The balance is non-secured, non interest bearing and has no fixed repayment terms.

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27 Accounts payable

	As at December 31	
	2006	2005
	RMB million	RMB million
0-30 days	**5,762**	6,281
31-60 days	**2,236**	1,796
61-90 days	**1,449**	1,297
91-180 days	**2,989**	1,940
Over 180 days	**5,218**	5,405
Total	**17,654**	16,719

Included in accounts payable are amounts due to other state-owned telecommunications operators amounting to RMB97 million on December 31, 2006.(2005: RMB48 million).

28 Accruals and other payables

	Group		Company	
	As at December 31		As at December 31	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
Accrued expenses	**549**	872	**136**	93
Other payables	**2,507**	3,033	**—**	—
Total	**3,056**	3,905	**136**	93

29 Bank and other loans

(a) (i) On July 20, 2006, the Group issued RMB10 billion one-year unsecured commercial papers in the PRC capital market and raised net cash proceeds of RMB9,676 million from this offering. The commercial papers are interest bearing at 3.35%.

(ii) The short term bank loans on December 31, 2006 were unsecured and comprise:

		As at December 31	
		2006	2005
Currency	**Interest rate and final maturity**	**RMB million**	RMB million
RMB denominated	Interest rates ranging from 4.86% to 5.51% per annum with maturity through December 26, 2007	**30,980**	47,341

The carrying values of short term bank loans approximate their fair values which are based on cash flows discounted using a rate based on the borrowing rate of 4.86%-5.51% (December 31, 2005: 4.70%-5.02%).

Included in the short-term bank loans were loans from state-owned banks amounting to RMB29,700 million as at December 31, 2006 (December 31, 2005: RMB46,541 million).

29 Bank and other loans *(continued)*

(b) The Group's long term bank and other loans comprise:

		As at December 31	
		2006	2005
	Note	**RMB million**	RMB million
Long term bank loans	(i)	**29,560**	22,734
Finance lease obligations	(ii)	**963**	2,255
		30,523	24,989
Less: Current portion		**(7,304)**	(6,846)
		23,219	18,143

The carrying values of the current portion of long term bank loans approximate their fair values which are based on cash flows discounted using a rate based on the borrowing rate of 6.12% (December 31, 2005: 5.58%).

Included in the long term bank loans were loans from state-owned banks amounting to RMB29,560 million as at December 31, 2006 (2005: RMB22,685 million).

(i) Long term bank loans

	As at December 31	
	2006	2005
	RMB million	RMB million
Loans		
Unsecured	**29,220**	22,414
Secured	**340**	320
Total	**29,560**	22,734
Less: Current portion	**(6,446)**	(5,579)
Long term loans	**23,114**	17,155

29 Bank and other loans *(continued)*

(b) The Group's long term bank and other loans comprise: *(continued)*

(i) Long term bank loans (continued)

The Group's long term bank loans were repayable as follows:

	As at December 31	
	2006	2005
	RMB million	RMB million
Within one year	**6,446**	5,579
In the second year	**6,491**	7,774
In the third to fifth year, inclusive	**9,723**	5,886
After the fifth year	**6,900**	3,495
	29,560	22,734

Currency	**Interest rate and final maturity**	As at December 31 **2006**	2005
		RMB million	RMB million
Bank loan			
Renminbi denominated	Interest rates ranging from 2.40% to 10.08% per annum with maturity through December 20, 2019	**28,128**	20,736
US Dollar denominated	Interest rates ranging from 1.25% to 6.44% per annum with maturity through October 31, 2039	**721**	1,241
Japanese Yen denominated	Interest rate is 2.12% per annum with maturity through January 7, 2014	**276**	327
Euro denominated	Interest rates ranging from 0.50% to 7.35% per annum with maturity through March 15, 2034	**435**	430
		29,560	22,734

29 Bank and other loans *(continued)*

(b) The Group's long term bank and other loans comprise: *(continued)*

(i) Long term bank loans (continued)

As at December 31, 2006, bank loans of RMB340 million (December 31, 2005: RMB320 million) were secured by the following:

- Corporate guarantees granted by China Netcom Group to the extent of RMB65 million (December 31, 2005: RMB75 million); and
- Corporate guarantees granted by third parties to the extent of RMB275 million (December 31, 2005: RMB245 million).

(ii) Finance lease obligations

	As at December 31	
	2006	2005
	RMB million	RMB million
Obligation under finance leases	**963**	2,255
Less: current portion	**(858)**	(1,267)
	105	988

The accumulated finance lease obligation as at December 31, 2006 amounted to RMB963 million. (2005: RMB2,255 million).

The interest rates charged on finance lease are ranging from2.68% to 6.83% with maturity through December 8, 2008 (2005: 2.50% to 5.70% with maturity through December 8, 2008).

29 Bank and other loans *(continued)*

(b) The Group's long term bank and other loans comprise: *(continued)*

(ii) Finance lease obligations (continued)

The Group's liabilities under finance leases are analyzed as follows:

	As at December 31	
	2006	2005
	RMB million	RMB million
Within one year	**888**	1,319
In the second year	**106**	903
In the third to fifth year, inclusive	**—**	106
	994	2,328
Less: future finance charges on finance leases	**(31)**	(73)
Present value of finance lease liabilities	**963**	2,255

The present value of finance lease liabilities is as follows:

	2006	2005
Within one year	**858**	1,267
In the second year	**105**	885
In the third to fifth year, inclusive	**—**	103
	963	2,255

(c) The fair value of the Group's non-current portion of long term bank and other loans at December 31, 2006 and 2005 were as follows:

	As at December 31	
	2006	2005
	RMB million	RMB million
Long term bank loans	**21,209**	15,571
Finance lease obligations	**85**	958
	21,294	16,529

The fair value is based on cash flows discounted using rates based on the borrowing rates of ranging from 3.75% to 8.33% (December 31, 2005: 2.54% to 6.12%).

30 Amount due from/(to) holding companies and fellow subsidiaries

	Note	As at December 31 **2006** **RMB million**	2005 RMB million
Current:			
Due from ultimate holding company	(a)	**173**	89
Due from other holding companies	(a)	**3**	1
Due from fellow subsidiaries	(a)	**176**	157
Total		**352**	247
Due to ultimate holding company			
–Deferred consideration	(b)	**1,960**	1,960
–Others	(a)	**3,282**	3,877
Due to fellow subsidiaries	(a)	**2,277**	3,153
Total		**7,519**	8,990
Non-current			
Due to ultimate holding company			
–Deferred consideration	(b)	**5,880**	7,840
Total		**5,880**	7,840

Note:

(a) These are interest free, unsecured and have no fixed terms of repayment.

(b) Balance represents the deferred payments arising from the Acquisition of New Horizon outstanding at year end. The balance is charged at interest rate of 5.265 % per annum with final maturity through June 30, 2010. The deferred payment is analyzed as follows:

	As at December 31 **2006** **RMB million**	2005 RMB million
Within one year	**1,960**	1,960
In the second year	**1,960**	1,960
In the third to fifth year, inclusive	**3,920**	5,880
Total	**7,840**	9,800

31 Deferred revenues

	As at December 31	
	2006	2005
	RMB million	RMB million
Balance at beginning of year		
–upfront connection fees	**5,505**	8,910
–upfront installation fees	**6,769**	7,638
–advances from network capacity sales	**2,354**	2,173
–prepaid telephony services	**4,272**	4,143
	18,900	22,864
Additions for the year		
–upfront connection fees	**—**	—
–upfront installation fees	**357**	573
–advances from network capacity sales	**236**	461
–prepaid telephony services	**30,360**	24,435
	30,953	25,469
Reductions for the year		
–upfront connection fees	**(2,406)**	(3,405)
–upfront installation fees	**(1,359)**	(1,442)
–advances from network capacity sales	**(2,590)**	(280)
–prepaid telephony services	**(29,567)**	(24,306)
	(35,922)	(29,433)
Included: Disposal of the ANC Group		
– advances from network capacity sales	**(2,450)**	—
– prepaid telephony services	**(144)**	—
	(2,594)	—
Balance at end of year		
– upfront connection fees	**3,099**	5,505
– upfront installation fees	**5,767**	6,769
– advances from network capacity sales	**—**	2,354
– prepaid telephony services	**5,065**	4,272
	13,931	18,900
Representing:		
– Current portion	**7,733**	7,975
– Non-current portion	**6,198**	10,925
	13,931	18,900

32 Provisions

	Early retirement benefits	One-off cash housing subsidies	Total
	RMB million	RMB million	RMB million
	Note a	Note a & b	
As at January 1, 2006	3,763	3,440	7,203
Additional provisions	—	—	—
Payments during the year	(626)	(255)	(881)
As at December 31, 2006	3,137	3,185	6,322
Analysis of total provisions:			
–Current portion	551	3,185	3,736
–Non-current portion	2,586	—	2,586
	3,137	3,185	6,322
As at January 1, 2005	4,192	3,509	7,701
Additional provisions	2	—	2
Payments during the year	(431)	(69)	(500)
As at December 31, 2005	3,763	3,440	7,203
Analysis of total provisions:			
–Current portion	589	3,440	4,029
–Non-current portion	3,174	—	3,174
	3,763	3,440	7,203

(a) Certain staff quarters, prior to 1998, have been sold to the Group's employees, subject to a number of eligibility requirements, at preferential prices. In 1998, the State Council issued a circular which stipulated that the sale of quarters to employees at preferential prices should be terminated. In 2000, the State Council issued a further circular stating that cash subsidies should be made to certain eligible employees following the withdrawal of the allocation of staff quarters. However, the specific timetable and procedures for the implementation of these policies were to be determined by individual provincial or municipal government based on the particular situation of the provinces or municipality.

Based on the relevant detailed local government regulations promulgated, certain entities within the Group have adopted cash housing subsidy plans. In accordance with these plans, for those eligible employees who had not been allocated with quarters or who had not been allocated with quarters up to the prescribed standards before the discounted sales of quarters were terminated, the Group is required to pay them one-off cash housing subsidies based on their years of service, positions and other criteria. Based on the available information, the Group estimated the required provision for these cash housing subsidies amounting to RMB4,142 million, which was charged to the consolidated income statement in the year ended December 31, 2000 when the State Council circular in respect of cash subsidies was issued.

32 Provisions *(continued)*

(b) Pursuant to the Listing Reorganization and the Acquisition of New Horizon, if the actual payments required for these subsidies and early retirement benefits differ from the amount provided as at June 30, 2004 and June 30, 2005, China Netcom Group will bear any additional payments required or will be paid the difference if the actual payments are lower than the amount provided.

33 Deferred taxation

Movements of the deferred tax assets and liabilities are as follows:

	Note	Balance on December 31, 2005	Recognized in income statement	Balance on Recognized in equity	Balance on December 31, 2006
		RMB million	RMB million	RMB million	RMB million
Deferred tax assets					
Deferred revenue, primarily advances from customers		170	(43)	—	127
Temporary differences from allowance for doubtful debts		350	(36)	—	314
Unrecognized revaluation surplus and deficit	(iii)	2,861	(51)	—	2,810
Others		99	109	—	208
Balance at end of year		3,480	(21)	—	3,459
Deferred tax liabilities					
Interest capitalized		(1,261)	472	—	(789)
Depreciation of fixed assets	(i)	—	52	(353)	(301)
Others		(63)	(3)	—	(66)
Balance at end of year		(1,324)	521	(353)	(1,156)
The amounts in the consolidated balance sheet are as follows:					
Deferred tax assets to be recovered after more than 12 months		2,906			2,860
Deferred tax liabilities to be settled after more than 12 months		(1,190)			(1,014)

Notes to the Consolidated Financial Statements

33 Deferred taxation *(continued)*

	Note	Balance at December 31, 2004	Recognized in income statement	Recognized in equity	Recognized in equity	Balance at December 31, 2005
		RMB million	RMB million	RMB million Note (ii)	RMB million Note (iii)	RMB million
Deferred tax assets						
Deferred revenue, primarily advances from customers		208	(29)	(9)	—	170
Temporary differences from allowance for doubtful debts		398	245	(293)	—	350
Unrecognized revaluation surplus and deficit	(iii)	2,114	(96)	—	843	2,861
Provision for early retirement benefits		597	(99)	(498)	—	—
Depreciation of fixed assets		325	95	(420)	—	—
Others		162	(10)	(53)	—	99
Balance at end of year		3,804	106	(1,273)	843	3,480
Deferred tax liabilities						
Interest capitalized		(1,489)	32	196	—	(1,261)
Others		(87)	24	—	—	(63)
Balance at end of year		(1,576)	56	196	—	(1,324)
The amounts in the consolidated balance sheet are as follows:						
Deferred tax assets to be recovered after more than 12 months		2,997				2,906
Deferred tax liabilities to be settled after more than 12 months		(1,318)				(1,190)

33 Deferred taxation *(continued)*

Notes:

(i) According to the Group's accounting policy as set out in note 4(k), the fixed assets other than buildings of the Group were revalued by the PRC valuer on a depreciated replacement cost basis as disclosed in note 20. The revalued amounts are not used to determine the tax bases of these assets in the future years. Accordingly, the Group's deferred tax liabilities on the balance sheet decreased by RMB150million. The net reduction comprised RMB353 million, being the deferred tax liabilities originated from the revaluation surplus of fixed assets which was debited to revaluation reserves, offset by RMB503 million, being the deferred tax assets originated from the revaluation deficit of fixed assets which was credited to profit and loss for the year.

(ii) In connection with the Listing Reorganization and the Acquisition of New Horizon, certain of the Group's telecommunication networks and equipment and furniture, fixtures, motor vehicles and other equipment were revalued as at December 31, 2003 and 2004. Such revalued amounts determine the tax bases for these assets for future years. In addition, except for the item described in Note (iii) below, the tax bases of certain assets and liabilities have been adjusted to the revalued amounts incorporated as the carrying values in the balance sheet.

In connection with the Acquisition of New Horizon, the Group's net deferred tax assets were subsequently reduced by RMB1,077 million (comprising deferred tax assets of RMB1,273 million and deferred tax liabilities of RMB196 million), and this decrease was recorded as a debit to owners' equity upon the date of the Reorganization on June 30, 2005. The RMB1,077 million deduction comprises RMB1,097 million, being deferred tax liabilities originating from the revaluation surplus of fixed assets recorded and credited to revaluation reserves offset by RMB2,174 million deferred tax assets debited to retained earnings.

(iii) In addition, in order to determine the tax bases used for future years after the Listing Reorganization and the Acquisition of New Horizon, the Group's up-front prepayments for the leasehold land and buildings were revalued for PRC tax purposes as at December 31, 2003 and 2004. However, the resulting revaluations of the up-front prepayments made for the leasehold land and buildings were not incorporated into the consolidated financial statements. As a result, deferred tax assets were subsequently recorded with corresponding increases in owners' equity upon the Listing Reorganization on June 30, 2004 and the Acquisition of New Horizon on June 30, 2005. In the opinion of the directors, it is more likely than not that the Group will realize the benefits of the deferred tax asset after making reference to the historical taxable income of the Group. The amount is to be transferred to retained earnings upon the corresponding realization of the underlying deferred tax assets.

During the Listing Reorganization, the leasehold land and buildings had a net surplus on revaluation of RMB6,967 million as at December 31, 2003. As explained in the preceding paragraph, a deferred tax asset of RMB2,355 million was subsequently recorded with a corresponding increase in owner's equity upon the Listing Reorganization on June 30, 2004.

During the Acquisition of New Horizon, the leasehold land and buildings had a net surplus on revaluation of RMB2,553 million as at December 31, 2005. As explained above, a deferred tax asset of RMB843 million was subsequently recorded with a corresponding increase in owner's equity upon the Acquisition on June 30, 2005.

The amount of transfer to retained earnings from unrecognized revaluation surplus and deficit for the year ended December 31, 2006 was RMB51 million. (Year 2005: RMB96 million).

34 Share capital

Authorized

	Ordinary shares of US$0.04 each			Convertible preference shares of US$0.04 each			Total	
	No of shares	US$	RMB Million	No of shares	US$	RMB Million	US$	RMB Million
As at January 1, 2005 and 2006, and December 31, 2006	25,000,000,000	1,000,000,000	8,277	7,741,782	309,671	3	1,000,309,671	8,280

Issued

	Ordinary shares of US$0.04 each			Convertible preference shares of US$0.04 each			Total	
	No of shares	US$	RMB million	No of shares	US$	RMB Million	US$	RMB Million
As at January 1, 2005 and 2006	6,593,529,000	263,741,160	2,181	—	—	—	263,741,160	2,181
Exercise of share option (Note)	57,114,500	2,284,580	18	—	—	—	2,284,580	18
As at December 31, 2006	6,650,643,500	266,025,740	2,199	—	—	—	266,025,740	2,199

Note: As at December 31, 2006, 40% of the 156,703,000 First Grant options (note 35) outstanding at January 1, 2006 were exercisable, of which 57,114,500 options (2005: Nil) were exercised during the year with an exercise price of HK$8.40. The total consideration received amounting to RMB490 million and the portion exceeds the nominal value of the shares issued was recorded as share premium of the Company.

35 Share option scheme

A share option scheme was approved pursuant to a directors' resolution on September 30, 2004 ("Share Option Scheme"). Share options are granted to directors of the Company and to certain employees of the Group at the directors' discretion. Share options can be exercised at least 18 months from the later of the date of grant or the date of the listing of the shares of the Company on the Hong Kong Stock Exchange and subject to certain vesting restrictions on timing.

On October 22, 2004, 158,640,000 share options with an exercise price of HK$8.40 each were granted to the directors of the Company and certain employees of the Group (the "First Grant").

Pursuant to the Company's share option plan, the Company granted 158,640,000 options to certain of its directors and employees, immediately prior to the closing of its global offering, to subscribe for its ordinary shares at the initial public offering price under the Hong Kong public offering, excluding brokerage and trading fees, and transaction and investor compensation levies. The First Grant has an exercise period of six years from the date of grant.

On December 6, 2005, the board of directors approved the granting of 79,320,000 shares of share options to certain management personnel and other professional personnel designated by the Compensation Committee of the newly acquired four northern provinces/autonomous region. ("Second Grant").

35 Share option scheme *(continued)*

The grant date fair value of the share options granted in the First Grant is determined by the Black-Scholes model based on the following assumptions: expected dividend pay-out ratio of 35%, expected vesting period of 5 years, expected volatility rate of 23.6% and risk-free interest rate of 4.3%. The weighted average fair value of the share options on grant date was determined as HK$ 1.22 per share (RMB1.28 per share). The grant date fair value of the share options granted in the Second Grant is determined by the Black-Scholes model based on the following assumptions: expected dividend pay-out ratio of 35%, expected vesting period of 4 years, expected volatility rate of 21.46% and risk-free interest rate of 4.3%. The weighted average fair value of the share option on grant date was determined as HK$1.28 per share (RMB1.34 per share). The model that decided the weighted average fair value of the share options and the assumptions mentioned above are subjective, and the changes of these subjective assumptions could affect the weighted average fair value of the share option. Therefore, Black-Scholes model may not reliably calculate the weighted average fair value of the share options.

Modifications to certain clauses of the share options schemes already granted were approved on May 16, 2006, pursuant to a resolution of the Extraordinary General Meeting. The modifications were mainly related to eligibility of the participants, number of options and exercise vesting schedules, rights upon cessation of employment, death and loss of capacity, performance targets, and cancellation of options. The modifications did not have significant impact to the financial statements.

The movement of the share options granted during the year is summarized as follows :

	No. of share options							
	As at January 1, 2005	Granted	Exercised	Lapsed	Cancelled	As at December 31, 2005	Exercise price	Weighted average closing price per share at respective days immediately before the exercises of options
							HK$	HK$
First Grant	157,720,000	—	—	—	1,017,000	156,703,000	8.4	—
Second Grant	—	79,320,000	—	—	—	79,320,000	12.45	—

	No. of share options							
	As at January 1, 2006	Granted	Exercised	Lapsed	Cancelled	As at December 31, 2006	Exercise price	Weighted average closing price per share at respective days immediately before the exercises of options
							HK$	HK$
First Grant	156,703,000	—	57,114,500	300	1,975,500	97,612,700	8.4	14.46
Second Grant	79,320,000	—	—	—	285,800	79,034,200	12.45	—

36 Reserves – Company

	Share premium RMB million	Capital reserve RMB million	Retained earnings RMB million	Total RMB million
As at January 1, 2005	42,750	3,000	(1,248)	44,502
Profit for the year	—	—	126	126
Dividends distributed during the year (Note 12)	—	—	(259)	(259)
Share based payments	—	104	—	104
As at December 31, 2005	42,750	3,104	(1,381)	44,473
Profit for the year	—	—	17,475	17,475
Dividends distributed during the year (Note 12)	—	—	(3,196)	(3,196)
Share based payments	—	75	—	75
Exercise of share options	545	(73)	—	472
As at December 31, 2006	43,295	3,106	12,898	59,299

37 Consolidated cash flow statements

(a) Reconciliation of profit before taxation to net cash flows generated from the operating activities of continuing operation.

	Year ended December 31	
	2006	2005
	RMB million	RMB million Restated Note 2
Profit before taxation	14,700	17,544
Depreciation of fixed assets and amortization of intangible assets	25,540	24,882
Lease prepayments for land	68	37
Amortization of deferred revenues	(33,137)	(29,482)
Deferred costs charged to the income statements	1,002	2,473
Deficit on revaluation of fixed assets	1,524	—
Bad and doubtful debts	1,009	1,148
Loss on disposal of fixed assets	606	360
Share-based compensation	75	104
Other income	(621)	—
Dividend income	—	(29)
Interest income	(132)	(131)
Interest expense	3,876	3,556
Foreign exchange gain	(8)	(229)
Operating cash flow before working capital changes	14,502	20,233
Increase in accounts receivable	(2,135)	(1,398)
Decrease in inventories and consumables	54	768
Decrease in prepayments, other receivables and other current assets	252	775
Increase in other non-current assets	(343)	(529)
Increase/(decrease) in accounts payable	1,221	(3,277)
Decrease in accruals and other payables	(3,115)	(1,374)
Increase in deferred revenues	30,614	25,434
Net cash inflow generated from operating activities of continuing operations	41,050	40,632

37 Consolidated cash flow statements *(continued)*

(b) Major non-cash transactions

During 2005, the Group paid RMB3,000 million out of the total consideration for the Acquisition of the New Horizon. The remaining balance of RMB9,800 million was recognized as a deferred payment and is included in amounts due to the ultimate holding company. During the year ended December 31, 2006, payments made in respect of the purchase were RMB1,960 million, the unpaid balance at December 31, 2006 was RMB7,840 million.

During 2005, the Group entered into finance lease arrangements in respect of newly acquired fixed assets with a total capital value at the inception of the lease of RMB338 million.

(c) Net investment gain from disposal of ANC Group

On June 2, 2006, the Group entered into an agreement to dispose of its entire interest in the ANC Group for a consideration of US$168.84 million. The disposal was completed on August 22, 2006. At the completion date, the net liabilities of the disposed ANC Group comprised:

	As at August 22, 2006
	RMB million
Net liabilities disposed of (excluding the cash and cash equivalents) :	
Accounts receivable and other current assets	**504**
Fixed assets and other non-current assets	**1,997**
Current portion of deferred income	**(308)**
Accounts payable and other current liabilities	**(592)**
Non-current portion of deferred income	**(2,286)**
Exchange differences realised	**(29)**
Net liabilities	**(714)**
Gain on disposal	**1,878**
Net cash inflow from disposal of ANC Group	**1,164**
Satisfied by :	
Cash consideration	**1,344**
Less : Cash and cash equivalents of ANC	**(180)**
Net cash inflow	**1,164**

38 Banking facilities

As at December 31, 2006 and 2005, the utilized and unutilized banking facilities are as follows:

	Group		Company	
	As at December 31		As at December 31	
	2006	2005	**2006**	2005
	RMB million	RMB million	**RMB million**	RMB million
Amount utilized	60,541	70,075	—	—
Amount unutilized	115,588	104,731	—	—
Aggregate banking facilities	176,129	174,806	—	—

39 Commitments

(a) Capital commitments

	As at December 31, 2006	As at December 31, 2005
	RMB million	RMB million
Contracted but not provided for		
– Leasehold land and buildings	**26**	215
– Telecommunication networks and equipment	**2,502**	1,357
– Others	**5**	112
Total	**2,533**	1,684
Authorized but not contracted for		
– Leasehold land and buildings	**—**	1
– Telecommunication networks and equipment	**300**	112
– Others	**—**	—
	300	113

39 Commitments *(continued)*

(b) Operating lease commitments

The Group has future minimum lease payments under non-cancelable operating leases in respect of premises and equipment as follows:

	As at December 31, 2006	As at December 31, 2005
	RMB million	RMB million
Not later than one year	**734**	583
Later than one year and not later than five years	**1,102**	527
Later than five years	**517**	186
Total	**2,353**	1,296

40 Related party transactions

All state-controlled enterprises, their subsidiaries, their key management and their close family, and their employees represent related parties of the Group as defined by HKAS 24. China Netcom Group, the Group's parent company, is a state-controlled enterprise directly controlled by the PRC government which controls different state-owned enterprises driving the economy of the PRC. The Group is the dominant fixed line telecommunications service provider in northern China by virtue of its historical monopoly over these services. As a result, the Group has extensive transactions including sales to, purchases of services, goods and fixed assets from, leasing of assets from and banking transactions with other state-owned parties in its ordinary course of business. These transactions are carried out at terms similar to those obtained by other state-owned parties and have been reflected in the financial statements.

The Group's operations are subject to the supervision of and regulation by the PRC Government. The Ministry of Information Industry (MII), pursuant to the authority delegated by the PRC's State Council, is responsible for formulating the policies and regulations for the telecommunications industry in China, including granting licenses, allocating frequency spectrum, formulating interconnection and settlement arrangements between telecommunications operators, enforcing industry regulations and reviewing tariffs for domestic services. Other PRC governmental authorities also regulate tariff policies, capital investment and foreign investment in the telecommunications industry.

As a state-owned telecommunication operator, the Group has extensive transactions with other state-owned telecommunication operators in its ordinary course of business. These transactions are carried out in accordance with the rules and regulations stipulated by the MII of the PRC Government and disclosed below.

The Group has extensive transactions with other members of the China Netcom Group. It is possible that the terms of the transactions between the Group and other members of the China Netcom Group are not the same as those that would result from transactions with other related parties or wholly unrelated parties.

Management believes that meaningful information relative to related party disclosures has been adequately disclosed.

40 Related party transactions *(continued)*

		Year ended December 31	
		2006	2005
	Notes	**RMB million**	RMB million
Emolument of key management			
– salaries and welfare and contributions to retirement scheme	(i)	**13**	23
Interconnection fees			
– from fellow subsidiaries	(iv)(b)	**381**	251
– from other state-owned telecommunications operators	(iv)(b)	**6,726**	6,442
Subtotal		**7,107**	6,693
Interconnection charges			
– to fellow subsidiaries	(iv)(b)	**820**	611
– to other state-owned telecommunications operators	(iv)(b)	**1,758**	1,475
Subtotal		**2,578**	2,086
Rental income from properties leased to fellow subsidiaries	(iv)(a),(iv)(c)	**2**	—
Purchase of materials			
– from fellow subsidiaries	(iv)(a),(iv)(c)	**1,170**	1,298
– from other related companies	(iv)(a),(iv)(c)	**122**	231
Subtotal		**1,292**	1,529
Receipt of engineering, project planning, design, construction and information technology services			
– from fellow subsidiaries	(iv)(a),(iv)(b)	**2,178**	2,236
– from other related companies	(iv)(a),(iv)(b)	**368**	413
Subtotal		**2,546**	2,649
Ancillary telecommunications support services			
– from fellow subsidiaries	(v),(iv)	**350**	435
– from other related companies	(v),(iv)	**58**	51
Subtotal		**408**	486

40 Related party transactions *(continued)*

	Notes	Year ended December 31 2006 RMB million	2005 RMB million
Payment of operating lease rentals of premises			
– to fellow subsidiaries	(iv)(a),(iv)(c)	**680**	655
Property sub-lease rentals to fellow subsidiaries	(iv)(a),(iv)(c)	**15**	15
Common corporate services income from ultimate holding company	(vi)	**121**	89
Common corporate services expenditure paid to ultimate holding company	(vi)	**448**	279
Support services received			
– from ultimate holding company	(vii), (iv)	**2**	2
– from fellow subsidiaries	(vii), (iv)	**712**	888
– from other related companies	(vii), (iv)	**23**	264
Subtotal		**737**	1,154
Telecommunications rental income from other state-owned telecommunications operators	(iv)(b)	**1,327**	1,271
Payment for lease of Telecommunications facility			
– to ultimate holding company	(viii)	**75**	85
– to fellow subsidiaries	(viii)	**307**	215
Subtotal		**382**	300
Payment for purchase of long-term telecommunications capacity to fellow subsidiaries	(ix),(xii)	**36**	117
Payment for lease of long-term telecommunications capacity to fellow subsidiaries	(x),(xii)	**65**	84
Management fee received from fellow subsidiaries	(xi),(xii)	**23**	39
Information communication technologies service received			
– from ultimate holding company	(xix),(iv)	**2**	—
– from fellow subsidiaries	(xix),(iv)	**34**	—
Subtotal		**36**	—

40 Related party transactions *(continued)*

Notes:

(i) Represents the emoluments paid to all of the directors and the top management of the Group, who are considered as the related parties of the Group.

(ii) The Group entered into finance lease arrangements with a related party, details have been set out in Note 29 (b)

(iii) Related party represents the non-listed investors of the fellow subsidiaries.

(iv) Priced based on one of the following three criteria:

(a) market price;

(b) prices based on government guidance; or

(c) cost plus basis.

(v) Represents provision of ancillary telecommunications support services to the Group by the fellow subsidiaries and the related companies. These services include certain telecommunications pre-sale, on-sale and after-sale services, certain sales agency services, the printing and delivery of invoice services, the maintenance of certain air-conditioning, fire alarm equipment and telephone booths and other customer services.

(vi) The Group entered into a Master Service Sharing agreement with China Netcom Group pursuant to which expenses associated with common corporate services is allocated between the Group and China Netcom Group based on total assets as appropriate.

(vii) Represents the support services provided to the Group by the fellow subsidiaries and the related companies. These support services include equipment leasing services, motor vehicles services, safety and security services, conference services, basic construction agency services, equipment maintenance services, employee training services, advertising services, printing services and other support services.

(viii) The Group entered into a Telecommunications Facilities Leasing Agreement with China Netcom Group pursuant to which the Group leases the international telecommunications facilities and inter-provincial transmission optic fibers from China Netcom Group. The lease payment is based on the depreciation charge of the assets.

(ix) The Group entered into a Capacity Purchase Agreement with East Asia Netcom Limited ("EANL"), a wholly owned subsidiary of China Netcom Group, pursuant to which the Group receives certain amounts of long-term telecommunications capacity from China Netcom Group at market prices as set out in the Capacity Purchase Agreement.

(x) The Group entered into a Capacity Lease Agreement with EANL, pursuant to which the Group leases certain amount of capacity of China Netcom Groiup's telecommunications network at market rates as set out in the Capacity lease Agreement.

(xi) The Group entered into a Management Services Agreement with EANL, pursuant to which the Group provides certain management services to China Netcom Group either on a cost reimbursement basis or on the basis of cost plus reasonable profits not exceeding the market price as set out in the Management Service Agreement.

(xii) Due to the disposal of ANC Group on August 22, 2006, the Capacity Purchase Agreement, the Capacity Lease Agreement and the Management Services Agreement between the Group and East Asia Netcom Ltd (a formerly wholly owned subsidiary of China Netcom Group) were no longer related party transactions to the Group after August 22, 2006.

(xiii) In addition, pursuant to the Listing Reorganization and the Acquisition of New Horizon, China Netcom Group have agreed to hold and maintain, for the Group's benefit, all licenses received from the MII in connection with the Restructured Businesses transferred to the Group. The licenses maintained by China Netcom Group were granted by the MII at nil or nominal costs. To the extent that China Netcom Group incurs a cost to maintain or obtain licenses in the future, the Company has agreed reimburse China Netcom Group for any such expense.

(xiv) China Netcom Group has also agreed to indemnify the Group in connection with any tax and deferred tax liabilities not recognized in the financial statements of the Group arising from transactions prior to the date of Listing Reorganization and the Acquisition of New Horizon in relation to the business of the Group prior to the Acquisition of New Horizon and the business of the acquired four provinces/autonomous region respectively.

40 Related party transactions *(continued)*

Notes: *(continued)*

(xv) As at December 31, 2006, China Netcom Group granted corporate guarantees to the Group as set out in Note 29(b).

(xvi) China Netcom Group, the Group's ultimate holding company, entered into an agreement (the "Sponsorship Agreement") with Beijing Organization Committee ("BOCOG") which designated China Netcom Group as the exclusive fixed-line telecommunications services partner in the People's Republic of China ("PRC") to sponsor the 2008 Beijing Olympic Games. China Netcom Group allocated the sponsorship fee to its members based on the estimated future benefits derived from the Sponsorship Agreement to respective members and the Group has contributed a portion of the required support under the Sponsorship Agreement through providing cash to BOCOG amounting to RMB0.54 billion. Accordingly, an intangible asset and a payable to the ultimate holding company of the said amount have been recognized on the Group's balance sheet.

(xvii) As at December 31, 2006, the Group has balances with other state-owned telecommunication service providers, cash deposited in and loans granted from state-owned banks as set out in Notes 17, 27, 16 and 29 respectively.

(xviii) For the year ended December 31, 2006, the deferred consideration in respect of the Acquisition of New Horizon paid to China Netcom Group amounted to RMB1,960 million, and the balance of the deferred consideration amounted to RMB7,840 million (2005: RMB9,800 million). The related interest charged for the year ended December, 31 2006 amounted to RMB567 million (2005: RMB87 million).

(xix) China Netcom System Integration, an indirect wholly owned subsidiary of the Company, entered into an Information and Communications Technology Agreement on November 7, 2006 with China Netcom Group. Pursuant to the Information and Communications Technology Agreement, China Netcom System Integration (and its subsidiaries) will provide Information Communications Technology Services to China Netcom Group. China Netcom System Integration will also subcontract services ancillary to the provision of Information Communications Technology Services, namely the System Installation and Configuration Services to the subsidiaries and branches of China Netcom Group in China Netcom Group's southern service region in PRC.

(xx) On December 31, 2006, the Group acquired certain fixed assets from China Netcom Group at a consideration of RMB81 million.

41 Significant subsequent events

(i) On January 15, 2007, CNC China entered into an assets transfer agreement with its ultimate holding Company, China Netcom Group. Pursuant to the agreement, CNC China agreed to dispose of its assets and liabilities in relation to its telecommunications operations in Guangdong Province and Shanghai Municipality branches in the PRC for consideration of RMB3.5 billion. China Netcom Group assumed an aggregate principal amount of RMB3 billion of debt which was due and owing from the Guangdong and Shanghai branches of the Group to independent third parties upon completion of the disposal. On February 14, 2007, the independent shareholders passed an ordinary resolution to approve the disposal. The disposal was completed on February 28, 2007 upon the approval granted from MII. The Group expects to recognise a pre-tax gain amounted to approximately RMB0.95 billion and the gain will be reported as part of the discontinued operations for the year ending December 31, 2007.

(ii) After the balance sheet date the directors proposed a final dividend. Further details are disclosed in Note 12.

(iii) On March 16, 2007, the National People's Congress approved the new PRC Enterprise Income Tax Law ("New Income Tax Law"). This legislation reduces the enterprise income tax rate for domestic enterprises from 33% to 25% with effect from 2008. The tax rate reduction will also affect the carrying value of the net deferred tax assets of the Group's domestic operations as HKAS 12 requires deferred tax items to be written down to reflect future realization at the newly enacted tax rate of 25% upon approval by the National People's Congress. The financial impact will be reflected in the financial statements for the year ending December 31, 2007. The Group cannot reasonably estimate the financial impact of the New Income Tax Law to the Group at this stage as the implementation measures to the New Income Tax Law was not yet finalized.

42 Ultimate holding party

The ultimate holding company is China Netcom Group which is owned and controlled by PRC Government.

43 Approval of financial statements

The financial statements were approved by the Board of Directors on April 2, 2007.