Management's Discussion and Analysis

MANAGEMENT REVIEW

- **Profit attributable to shareholders was HK$1,638 million or basic earnings per share of 30.50 HK cents**
- **Proposed final dividend of 9.6 HK cents per share**
- **Operating costs before depreciation and amortization reduced 10% to HK$5,812 million**
- **Net Debt reduced by 10% to HK$26,200 million**
- **Achieved significant breakthroughs in regulatory reform**
- **Unlocked market value of property assets**
- **Established strategic alliance with China Network Communications Group Corporation**

FINANCIAL REVIEW BY SEGMENTS

For the year ended December 31, HK$ million	2004 H1	2004 H2	2004 Full Year	2003 H1	2003 H2	2003 Full Year	Better/ (Worse) y-o-y
Revenue							
Telecommunications Services ("TSS")	**7,496**	**7,731**	**15,227**	8,386	8,186	16,572	(8)%
Business eSolutions[2]	**1,312**	**1,389**	**2,701**	1,141	1,185	2,326	16%
Infrastructure	**2,321**	**3,542**	**5,863**	1,697	2,903	4,600	27%
Infrastructure (ex. Bel-Air)	***225***	***223***	***448***	*250*	*239*	*489*	*(8)%*
Bel-Air	***2,096***	***3,319***	***5,415***	*1,447*	*2,664*	*4,111*	*32%*
Others	**194**	**178**	**372**	165	261	426	(13)%
Elimination	**(597)**	**(671)**	**(1,268)**	(663)	(711)	(1,374)	8%
Total Revenue	**10,726**	**12,169**	**22,895**	10,726	11,824	22,550	2%
Cost of sales	**(4,536)**	**(5,995)**	**(10,531)**	(3,675)	(5,055)	(8,730)	(21)%
Operating costs before depreciation and amortization	**(3,012)**	**(2,800)**	**(5,812)**	(3,189)	(3,259)	(6,448)	10%
EBITDA[3]							
TSS	**3,294**	**3,437**	**6,731**	4,276	4,015	8,291	(19)%
Business eSolutions[2]	**72**	**16**	**88**	80	(35)	45	96%
Infrastructure	**358**	**416**	**774**	143	118	261	197%
Infrastructure (ex. Bel-Air)	***145***	***79***	***224***	*142*	*108*	*250*	*(10)%*
Bel-Air	***213***	***337***	***550***	*1*	*10*	*11*	*>500%*
Others	**(546)**	**(495)**	**(1,041)**	(637)	(588)	(1,225)	15%
Total EBITDA	**3,178**	**3,374**	**6,552**	3,862	3,510	7,372	(11)%
Group EBITDA Margin	**30%**	**28%**	**29%**	36%	30%	33%	(4)%
EBITDA Margin (ex. Bel-Air)	**34%**	**34%**	**34%**	42%	38%	40%	(6)%
Depreciation and amortization	**(1,260)**	**(1,282)**	**(2,542)**	(1,432)	(1,456)	(2,888)	12%
Gain/(Loss) on disposal of fixed assets	**75**	**(19)**	**56**	(72)	(73)	(145)	NA
Operating profit before net gains on investments, provisions for impairment losses and restructuring costs	**1,993**	**2,073**	**4,066**	2,358	1,981	4,339	(6)%

REVENUE

Consolidated revenue of the Group for the year ended December 31, 2004 increased by 2% to HK$22,895 million. The increase in revenue was attributable in part to the higher revenue contribution from the Group's Unihub business and continuing broadband growth. The Group's property flagship, Pacific Century Premium Developments Limited ("PCPD"), recorded a significantly higher level of Bel-Air sales in 2004 as it continued to benefit from the rising property market prices in Hong Kong. The increase in revenue from these sources was partially offset by a reduction in revenue contribution from certain traditional telecommunications services.

OPERATING DRIVERS	**2004**		2003		Better/ (Worse)
	H1	**H2**	H1	H2	y-o-y
Exchange lines in service ('000)	**2,662**	**2,567**	2,933	2,779	(8)%
Business lines ('000)	**1,175**	**1,144**	1,266	1,236	(7)%
Residential lines ('000)	**1,487**	**1,423**	1,667	1,543	(8)%
Fixed line market share	**70%**	**68%**	77%	73%	(5)%
Business lines	**71%**	**69%**	75%	73%	(4)%
Residential lines	**70%**	**67%**	78%	73%	(6)%
New Generation Fixed-Line ("NGFL") sign-ups ('000)	**849**	**969**	–	655	48%
now Broadband TV installed ('000)	**269**	**361**	–	147	146%
Total broadband access lines ('000) (Consumer, business and wholesale customers)	**753**	**796**	629	703	13%
Retail consumer broadband subscribers ('000)	**558**	**660**	460	517	28%
Retail business broadband subscribers ('000)	**68**	**74**	58	63	17%
Consumer narrowband subscribers ('000)	**160**	**148**	196	175	(15)%
Traditional data (Exit Gbps)	**211**	**234**	181	190	23%
Retail International Direct Dial ("IDD") minutes[4] ('M mins)	**661**	**722**	596	630	13%
International Private Leased Circuit ("IPLC") bandwidth (Exit Mbps)	**4,822**	**6,020**	1,265	1,592	278%

Note 1 Net Debt refers to short-term and long-term borrowings minus cash and cash equivalents.

Note 2 Business eSolutions included IT business provided under Unihub, retail business broadband and the Group's directories businesses.

Note 3 EBITDA represents earnings before interest, taxation, depreciation, amortization, gain/loss on disposal of fixed assets, net gains on investments, provisions for impairment losses, restructuring costs, impairment losses on interests in jointly controlled companies and associates, other income and the Group's share of results of jointly controlled companies and associates. While EBITDA is commonly used in the telecommunications industry worldwide as an indicator of operating performance, leverage and liquidity, it is not presented as a measure of operating performance in accordance with accounting principles generally accepted in Hong Kong and should not be considered as representing net cash flows from operating activities. The computation of the Group's EBITDA may not be comparable to similarly titled measures of other companies.

Note 4 Year-on-year percentage change was based on total IDD minutes for the year.

TSS

During 2004, TSS continued to actively manage its business and operations in response to the challenging operating, competitive and regulatory environment in Hong Kong's telecommunications market. The unit continued to improve its innovative products including NGFL services, now Broadband TV and PCCW Convergence. The Group's investments in value-added services, data transmission services and broadband services, and its quality of services are seen as key differentiators against competitors.

The table below sets out the financial performance of TSS for the years ended December 31, 2004 and 2003:

For the year ended December 31, HK$ million	**2004** H1	H2	Full Year	2003 H1	H2	Full Year	Better/ (Worse) y-o-y
Local Telephony Services	**2,686**	**2,617**	**5,303**	3,071	2,953	6,024	(12)%
Local Data Services	**2,164**	**2,222**	**4,386**	2,234	2,162	4,396	0%
International Telecommunications Services	**1,176**	**1,209**	**2,385**	1,536	1,434	2,970	(20)%
Other Services	**1,470**	**1,683**	**3,153**	1,545	1,637	3,182	(1)%
TSS Revenue	**7,496**	**7,731**	**15,227**	8,386	8,186	16,572	(8)%
Cost of sales	**(2,006)**	**(2,268)**	**(4,274)**	(1,859)	(1,929)	(3,788)	(13)%
Operating costs before depreciation and amortization	**(2,196)**	**(2,026)**	**(4,222)**	(2,251)	(2,242)	(4,493)	6%
TSS EBITDA	**3,294**	**3,437**	**6,731**	4,276	4,015	8,291	(19)%
TSS EBITDA Margin	**44%**	**44%**	**44%**	51%	49%	50%	(6)%

TSS revenue for the year ended December 31, 2004 decreased 8% to HK$15,227 million due to the continuing fierce competition in the Hong Kong telecommunications market.

Local Telephony Services. Revenue from local telephony services for the year ended December 31, 2004 decreased 12% year-on-year to HK$5,303 million. This primarily reflected a reduction in the overall number of direct exchange lines in service operated by the Group as a result of the competition from other network operators, and substitution by broadband access lines and wireless telecommunications services. Certain interconnection fees were lower due to a rate reduction as determined by Office of the Telecommunications Authority ("OFTA") effective October 2003.

The Group continued to launch various marketing programmes to retain and win-back fixed line customers. Functionalities of NGFL services have been enhanced and 969,000 lines were signed up by the end of 2004. Net line loss reduced from 359,000 to 212,000 on a year-on-year basis.

According to industry statistics provided by OFTA and the Group's estimate, the total number of direct exchange lines in the fixed line market contracted by 1.1% in 2004 (2003: 0.6%). At the end of 2004, the Group operated approximately 2,567,000 direct exchange lines with overall market share at 68%.

Local Data Services. Local data services revenue for the year ended December 31, 2004 declined marginally year-on-year to HK$4,386 million. Total broadband access lines continued to grow by 13% to 796,000 as at December 31, 2004 while now Broadband TV services installed reached 361,000. Increase in broadband and now Broadband TV revenue counter-balanced the decline in revenue due to severe pricing pressure in the provision of local area and wide area (LAN and WAN) corporate networks, and high-speed, high-volume data transmissions from mobile telephone operators and Internet service providers.

International Telecommunications Services. International telecommunications services revenue for the year ended December 31, 2004 decreased 20% year-on-year to HK$2,385 million. This market segment continued to experience competitive decrease in retail prices while traffic volume rose strongly. IPLC bandwidth sold increased to 6,020 Mbps while retail outgoing IDD traffic increased 13% to 1,383 million minutes. Unit prices of IPLC, IDD and other international data products were lower than those in 2003, in line with the global market trend. Delivery fee revenue also dropped due to a rate reduction as determined by OFTA effective June 2004.

Other Services. Other services revenue for the year ended December 31, 2004 decreased 1% year-on-year to HK$3,153 million. The decline in customer premise equipment sales revenue was partially offset by an increase in technical consultancy and network operation outsourcing services revenue generated by Cascade.

Business eSolutions (including Unihub)

The table below sets out the financial performance of Business eSolutions for the years ended December 31, 2004 and 2003:

For the year ended December 31, HK$ million	**2004**	2003	Better/ (Worse) y-o-y
Unihub	**1,865**	1,525	22%
Retail business broadband	**547**	530	3%
Directories	**289**	271	7%
Business eSolutions Revenue	**2,701**	2,326	16%
Business eSolutions EBITDA	**88**	45	96%

Business eSolutions revenue for the year ended December 31, 2004 increased 16% to HK$2,701 million primarily due to a more significant revenue contribution from Unihub, including the business from Unihub China Information Technology Company Limited, the Company's subsidiary co-owned with China Telecommunications Corporation ("China Telecom") established in 2003.

Infrastructure

Infrastructure revenue for the year ended December 31, 2004 increased 27% to HK$5,863 million, primarily representing the contribution from PCPD. The surge in revenue reflected strong sales of Bel-Air luxury apartments. Average selling price was higher in 2004 riding on more favorable property market conditions.

On May 10, 2004, a majority of the property interests previously held by the Group were transferred to a separately listed company, Dong Fang Gas Holdings Limited ("DFG"), which was subsequently renamed Pacific Century Premium Developments Limited. Management believed that the transaction would unlock the value of the Group's property portfolio, provide a separate platform to pursue new property development projects and create additional value for PCCW's shareholders. As at December 31, 2004, the Company had sold down its interest in PCPD to approximately 51.07%.

Subsequent to the year end, the Company converted the Tranche A of the Convertible Notes (as defined in the shareholder circular of the Company dated March 26, 2004) effective March 1, 2005. Its stake in PCPD was then raised to approximately 61.66%.

For more information about the performance of the Infrastructure segment, please refer to the 2004 annual results of PCPD released on March 30, 2005.

Others and Elimination

Other revenue primarily included revenue from the Group's businesses in Taiwan and Japan. The Group continued to streamline certain loss-making businesses including the gaming business in Japan. Thus, other revenue decreased 13% to HK$372 million.

Elimination of HK$1,268 million predominantly relates to internal charges for communications services consumed, IT support and computer system network charges, customer support services and rental between the Group's business units.

COSTS

Total cost of sales for the year ended December 31, 2004 increased 21% to HK$10,531 million, due to a higher cost of properties sold in relation to the Cyberport project, an increase in cost of sales in relation to Unihub business in mainland China, including the Group's subsidiary co-owned with China Telecom, and an increase in marketing and customer acquisition costs of new products and services, such as now Broadband TV and NGFL services.

For the year ended December 31, HK$ million	2004	2003	Better/ (Worse) y-o-y
Staff costs	**2,903**	3,150	8%
Repair and maintenance	**358**	423	15%
Other operating costs	**2,551**	2,875	11%
Total operating costs before depreciation and amortization	**5,812**	6,448	10%
Depreciation and amortization	**2,542**	2,888	12%
(Gain)/Loss on disposal of fixed assets	**(56)**	145	NA
General and administrative expenses	**8,298**	9,481	12%

The Group achieved 10% savings in total operating costs before depreciation and amortization during the year by streamlining certain loss-making businesses including the gaming business in Japan, improving corporate overhead efficiency and overall productivity level, and restructuring its defined benefit schemes. The Group recognized some development costs for its wireless broadband network business in the United Kingdom which offset a portion of the savings in total operating costs.

EBITDA[3]

Group EBITDA for the year ended December 31, 2004 decreased 11% year-on-year to HK$6,552 million. The decrease was primarily attributable to the lower EBITDA contribution from TSS, partially offset by a more significant contribution from Bel-Air sales, and a reduction in EBITDA loss from the Group's business in Japan and from cost savings in corporate overhead.

Group EBITDA margin for the year ended December 31, 2004 narrowed to 29%. This was primarily due to a lower TSS EBITDA margin as a result of the change in business mix and the marketing and customer acquisition costs in relation to the new products and services incurred in 2004. The decrease in TSS margin was partially offset by a higher margin contribution from Bel-Air sales.

REACH

Reach Ltd. ("REACH"), a 50:50 venture with Telstra Corporation Limited ("Telstra"), generated HK$6,300 million (2003: HK$7,036 million) in revenue and HK$783 million (2003: HK$733 million) in EBITDA for the year ended December 31, 2004. REACH continues to operate in a difficult environment and the industry is expected to remain challenging for some time. Prices for international voice and data carriage have been falling and the growth in usage has not been sufficient to compensate for the loss in revenue caused by the price reductions. REACH is continuing to focus on core business and cost containment. In addition, a suite of new IT systems platforms have been progressively introduced to enhance operational performance and customer satisfaction.

In June 2004, the Company and Telstra agreed to purchase from the syndicate of banks the entire outstanding portion of US$1,200 million of the debt under the amended US$1,500 million syndicated term loan facility (the "REACH Term Facility") for approximately US$311 million (approximately HK$2,425 million). The Company's 50% share was approximately US$155.45 million (approximately HK$1,213 million). Management believed that the restructuring plan was in line with other similar agreements in the undersea cable sector and reflected the difficult economic reality of the industry. The arrangement strengthened REACH's financial position by reducing the cash flow burden of interest paid to the syndicate of banks. REACH's business continuity would also be more secure thereby allowing it to continue to focus on improving efficiency and competitiveness.

In 2003, the Group performed an impairment assessment of its interests in REACH and wrote down its total investment to zero. As a result, no equity profit/loss pick up from REACH was required by the Group in 2004.

Net Finance Costs

Net finance costs for the year ended December 31, 2004 decreased 9% to HK$1,929 million, in line with the 10% decrease in Net Debt[1]. The Group prudently managed its debt profile and the interest rate risk by moving the majority of debt from floating to fixed rates. Average cost of debt increased to 6.1% from 5.6% year-on-year.

Taxation

Taxation for the year ended December 31, 2004 decreased 16% to HK$981 million. Under the current tax system in Hong Kong, there is no group loss relief on Hong Kong and overseas operating losses. Furthermore, the Group's financing costs, to the extent that they are attributable to the acquisition of PCCW-HKT Limited ("HKT") and other companies, are not tax deductible. Excluding these factors, the Group has an effective tax rate which is approximately the statutory tax rate of 17.5%. Management will continue to review and minimize the overall tax costs, subject to the constraints of the existing Hong Kong tax rules.

Profit Attributable to Shareholders

Profit attributable to shareholders in 2004 was HK$1,638 million compared to a loss of HK$6,100 million in 2003 primarily due to the significant asset and investment impairment losses recorded and operating loss picked up from REACH in the previous year.

LIQUIDITY AND CAPITAL RESOURCES

The Group continued to deleverage and reduced Net Debt[1] by 10% to HK$26,200 million as at December 31, 2004 from HK$29,131 million a year ago. Weighted average maturity was about 6 years. As at December 31, 2004, PCCW-HKT Telephone Limited ("HKTC") had a total of HK$10,800 million committed medium-term revolving credit facilities which remained undrawn at year end.

As part of the REACH restructuring plan, the Company paid approximately US$155.45 million (approximately HK$1,213 million) for a 50% share of the REACH Term Facility in June 2004. For details, see the "REACH" section.

The remaining construction costs of the Cyberport project, including Bel-Air, is fully funded by the total sales proceeds received. In August 2004, the first portion of the surplus proceeds was allocated between the Government and PCCW of approximately HK$1,675 million and HK$920 million respectively.

During the year, the Group established PCPD as a separately listed company and entered into several share placement transactions. A total of 687 million old PCPD shares were placed and 118 million new PCPD shares were issued, generating approximately HK$2,001 million of gross proceeds.

Subsequent to the year end, PCCW Tower, the Group's headquarters in Hong Kong, was disposed of in February 2005 at a cash consideration of HK$2,808 million.

On March 16, 2005, the strategic alliance transaction between the Company and China Network Communications Group Corporation ("China Netcom Group") was approved by the shareholders of PCCW. China Netcom Group has agreed to pay approximately HK$7.9 billion in cash for a 20% stake in the enlarged issued share capital of the Company. Subject to the Group's capital investment procedures and the identification of appropriate investment opportunities, the Company intends to invest up to HK$5 billion of these proceeds in telecommunications opportunities in the PRC. The remainder will be used for reducing the Group's debt and general corporate purposes.

The Directors consider that it is not meaningful to publish a gearing ratio for the Group until such time as the Group is in a positive shareholders' equity position.

Credit Ratings of HKTC

As of December 31, 2004, HKTC had investment grade ratings with Standard & Poor's Ratings Services (BBB/CreditWatch Developing), Moody's Investors Service (Baa2/stable) and Fitch Ratings (BBB+/stable). On August 27, 2004, Standard & Poor's placed the rating of HKTC on CreditWatch with developing implications in view of the potential strategic alliance between the Company and China Netcom Group. All the rating agencies affirmed their ratings after the Company and China Netcom Group jointly announced their strategic alliance in January 2005.

CAPITAL EXPENDITURE

Capital expenditure for the year ended December 31, 2004 remained stable at HK$1,972 million. The majority of capital expenditure was spent on new initiatives including now Broadband TV, UK Broadband project, NGFL services, broadband access lines, and data services.

PCCW has made significant investment in its communications network in previous years. This has included the upgrade and expansion of network coverage, and building a platform for broadband and fast developing IP initiatives. Besides on-going core network expansion, the capital expenditure in 2005 will include overseas network projects and other new products and services. PCCW will continue to invest prudently, using criteria including internal rate of return, net present value and payback period.

HEDGING

Market risk arises from foreign currency exposure and interest rate exposure related to cash investments and borrowings. As a matter of policy, the Group continues to manage the market risk directly relating to its operations and financing and does not undertake any speculative derivative trading activities. The Finance and Management Committee, a subcommittee of the Executive Committee of the Board of Directors, determines appropriate risk management activities undertaken with the aim of managing prudently the market risk associated with transactions undertaken in the normal course of the Group's business. All treasury risk management activities are carried out in accordance with policies and guidelines approved by the Finance and Management Committee and the Executive Committee, which are reviewed on a regular basis.

In the normal course of business, the Group enters into forward contracts and other derivative contracts in order to limit its exposure to adverse fluctuations in foreign currency exchange rates and interest rates. These instruments are executed with creditworthy financial institutions, and all contracts are denominated in currencies of major industrial countries. Gains and losses on these contracts serve as hedges in that they offset fluctuations that would otherwise impact the Group's financial results. Costs associated with entering into such contracts are not material to the Group's financial results.

CHARGE ON ASSETS

As at December 31, 2004, certain assets of the Group with an aggregate carrying value of HK$67 million (2003: HK$4,188 million) were pledged to secure loan and borrowing facilities utilized by the Group. Certain other investments, with an aggregate value of HK$224 million (2003: HK$246 million), were placed as collateral in relation to certain equity-linked transactions entered into by the Group in 2002. The Group's interest in REACH was also used to secure the amended US$54 million 5% mandatory convertible note due 2005.

CONTINGENT LIABILITIES

As at December 31, HK$ million	**2004**	2003
Performance guarantee	**129**	130
Others	**119**	125
	248	255

Apart from the above, on April 23, 2002, a writ of summons was issued against HKT, an indirect wholly-owned subsidiary of the Company, by New Century Infocomm Tech Co., Ltd. for HKT's failure to purchase 6,522,000 shares of Taiwan Telecommunication Network Services Co., Ltd. ("TTNS"), an indirect subsidiary of the Company, pursuant to an option agreement entered into on July 24, 2000. The total claim against HKT amounted to approximately HK$103 million (NT$418 million), being the purchase price of shares in TTNS, contractual interest for the period from January 1, 2001 to January 2, 2002 at 6.725% per annum and interest on the due amount pursuant to Sections 48 and 49 of the High Court Ordinance, Cap. 4. However, this figure should be reduced by the current market value of the shares in TTNS which would be transferred to HKT in the event that the claimants are successful in their claim. A defence was filed by HKT on May 29, 2002 and proceedings are ongoing. Based on legal advice received, the Directors consider that HKT has valid defences and therefore no provision has been made.

HKTC has been in dispute with Hong Kong's Inland Revenue Department (the "IRD") regarding the deductibility of certain interest payments totalling HK$1,708 million in the 2003 and 2004 tax computations. Subsequent to the balance sheet date, HKTC received official notification from the IRD in respect of its intention to disallow the deduction of interest payments in dispute and to issue additional assessments. The Directors consider that their grounds for claiming the deduction are reasonable and will lodge a formal objection to the IRD against the additional assessments and accordingly no provision for taxation has been made in the financial statements of the Group.

HUMAN RESOURCES

As at December 31, 2004, the Group had approximately 12,248 employees (2003: 12,510). The majority of these employees work in Hong Kong. The Company has established incentive bonus schemes designed to motivate and reward employees at all levels to achieve the Company's business performance targets. Payment of bonuses was generally based on achievement of revenue and EBITDA targets for the Company's individual businesses and the Group as a whole. The Company also operates a discretionary employee share option scheme and two share award schemes to motivate employee performance in enhancing shareholder value.

DIVIDEND

The Board of Directors has recommended the payment of a final dividend of 9.6 HK cents per share (2003: Nil) for the year ended December 31, 2004 subject to the approval of the shareholders of the Company at the forthcoming annual general meeting. An interim dividend of 5.5 HK cents per share (2003: Nil) was paid by the Company on November 25, 2004.