



Report of the Directors

The directors are pleased to present their annual report together with the audited financial statements for the year ended December 31, 2006.

Principal activities

The Group is a dominant provider of fixed-line telephone services, broadband, other internet-related services, and business and data communications services in ten northern municipalities and provinces in China, namely Beijing Municipality, Tianjin Municipality, Hebei Province, Henan Province, Shandong Province, Liaoning Province, Heilongjiang Province, Jilin Province, Neimenggu Autonomous Region and Shanxi Province. The principal activity of the Company is investment holding.

In 2006, the Group also provided telecommunications services to selected business and residential customers in two southern municipality and province, namely Guangdong Province and Shanghai Municipality in China, and operated an extensive network and offered international data services in the Asia Pacific region. After the completion of the disposal of 100% equity interest in Asia Netcom Corporation Limited ("Asia Netcom") in August 2006, the Group no longer operates network and offers international data services in the Asia Pacific region. After the completion of the disposal of the Group's telecommunications assets, liabilities and business operations in Guangdong Province and Shanghai Municipality on February 28, 2007, the Group no longer provides telecommunications services in such two southern municipality and province.

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

Major customers and suppliers

The Group's aggregate sales attributable to its five largest customers did not exceed 30 per cent. of the Group's total sales in 2006.

The Group's aggregate purchases from its five largest suppliers did not exceed 30 per cent. of the Group's total purchases in 2006.

Subsidiaries

Particulars of the Company's subsidiaries as at December 31, 2006 are set out in note 26 to the financial statements.

Financial statements

The results of the Group for the year ended December 31, 2006 and the Company's and the Group's financial positions as at that date are set out in the financial statements on pages 77 to 144.

Dividends

The Company has always held in the highest regard for the interests of and returns achieved for its shareholders. Having taken into account such factors as our results of operations, cash flows, financial condition, future prospects, and statutory and regulatory restrictions on the payment of dividend by the Company, the Board recommends payment of a final dividend of HK\$0.553 per share for the financial year ended December 31, 2006. The dividend payout ratio for 2006 is 35%. If the relevant resolution relating to declaration of dividend is passed, the dividend will be distributed on or about June 12, 2007 to shareholders whose names are registered on the Company's shareholders' register on May 22, 2007.

Charitable donations

Donations made by the Group during the year amounted to RMB0.53 million (2005: RMB 0.8 million).

Fixed assets

Changes of the fixed assets of the Group and the Company during the year are set out in note 20 to the financial statements.



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Bank and other loans

Particulars of bank and other loans of the Group as at December 31, 2006 are set out in note 29 to the financial statements.

Share capital and share option scheme

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

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

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

Reserves

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

Financial summary

A summary of the audited results and of the audited assets and liabilities of the Group for the last five financial years is set out on pages 152 to 154.

Connected Transactions

As at December 31, 2006, China Netcom Group, as the ultimate controlling shareholder of the Company, beneficially owned 69.88% of the Company's issued share capital. China Netcom Group is therefore a connected person of the Company. On September 12, 2005, China Netcom Group, CNC China and China Netcom Group New Horizon Communications Corporation Limited ("**New Horizon Communications**", an indirect wholly-owned subsidiary of the Company) entered into certain connected transaction agreements to regulate the continuing connected transactions between China Netcom Group and its subsidiaries or associates (other than the Group) on one hand and the Group on the other in respect of the Group's operation in 12 provinces, autonomous regions and municipalities in China. CNC China completed its merger with New Horizon Communications on November 3, 2006 ("**Merger**"). Pursuant to the aforesaid connected transaction agreements, all New Horizon Communications' rights and obligations under the agreements were taken over by CNC China after the Merger and the agreements remained effective between China Netcom Group and CNC China. Therefore, certain ongoing transactions between CNC China and New Horizon Communications (CNC China alone as one party after the Merger) on the one hand and China Netcom Group and its subsidiaries or associates (other than the Group) on the other ("**Continuing connected transactions relating to CNC China and New Horizon Communications**") were conducted in accordance with the provisions of the connected transaction agreements entered into on September 12, 2005.

The Company established China Netcom Group System Integration Limited Corporation ("**China Netcom System Integration**") as an indirect wholly-owned subsidiary in April 2006. China Netcom System Integration entered into certain transactions with China Netcom Group (and its subsidiaries), and on November 7, 2006, China Netcom System Integration entered into a connected transaction agreement ("**Information and Communications Technology Agreement**") with China Netcom Group.

On June 30, 2004, Asia Netcom, a former wholly-owned subsidiary of the Company, entered in certain transactions and a series of connected transaction agreements with East Asia Netcom Ltd. ("**EANL**"), a connected person of the Company by virtue of being an indirect wholly-owned subsidiary of China Netcom Group. On June 2, 2006, a share purchase agreement was entered among the Company, China Netcom Corporation International Limited ("**CNCI**", a wholly-owned subsidiary of the Company), and two third parties, pursuant to which CNCI sold 100% of its equity interests in Asia Netcom. The share sale was completed on August 22, 2006. After completion of the share sale, transactions between Asia Netcom and EANL will no longer constitute continuing connected transactions of the Company under the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the "**Listing Rules**").



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These transactions between CNC China, New Horizon Communications and China Netcom Group, between China Netcom System Integration and China Netcom Group, and between Asia Netcom and EANL (the “**Continuing Connected Transactions**”) constitute continuing connected transactions of the Company under the Listing Rules. Details of the Continuing Connected Transactions are set out below and in note — to the financial statements. For the financial year ended December 31, 2006, the Continuing Connected Transactions have not exceeded their respective upper limits set by the Hong Kong Stock Exchange. In respect of all the connected transactions of the Company as stated in this report, the Company has complied with the disclosure requirements under the Listing Rules in force from time to time.

Continuing connected transactions relating to CNC China and New Horizon Communications

Domestic Interconnection Settlement Agreement

Pursuant to the Domestic Interconnection Settlement Agreement:

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

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

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

International Long Distance Voice Services Settlement Agreement

Pursuant to the International Long Distance Voice Services Settlement Agreement:

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

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

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

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



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Property Leasing Agreement

Pursuant to the Property Leasing Agreement:

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

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

Property Sub-leasing Agreement

Pursuant to the Property Sub-leasing Agreement:

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

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

Master Sharing Agreement

Pursuant to the Master Sharing Agreement:

- (i) The Combined Operating Group will provide customer relationship management services for large enterprise customers of China Netcom Group;
- (ii) The Combined Operating Group will provide network management services to China Netcom Group;
- (iii) The Combined Operating Group will share with China Netcom Group the services provided by administrative and managerial staff in respect of central management of the business operations, financial control, operation and maintenance of network, human resources and other related matters of both the Combined Operating Group and China Netcom Group;
- (iv) The Combined Operating Group will provide to China Netcom Group supporting services such as billing and settlement provided by the business support centre;
- (v) China Netcom Group will provide to the Combined Operating Group supporting services, including telephone card production, development and related services and IC card inter-provincial and inter-network clearing services;
- (vi) China Netcom Group will provide to the Combined Operating Group certain other shared services, including advertising, publicity, research and development, business hospitality, maintenance and property management; and



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- (vii) China Netcom Group will provide certain office space in its headquarters to the Combined Operating Group for use as its principal executive office.
- (viii) The Combined Operating Group and China Netcom Group will share the revenues received by China Netcom Group from other operators whose networks interconnect with the Internet backbone network of China Netcom Group and will share the monthly connection fee that China Netcom Group pays to the State Internet Switching Centre.

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

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

Engineering and Information Technology Services Agreement

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

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

Materials Procurement Agreement

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

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

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



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

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

Ancillary Telecommunications Services Agreement

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

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

Support Services Agreement

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

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

Telecommunications Facilities Leasing Agreement

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

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

Continuing Connected Transaction Relating to China Netcom System Integration

Information and Communications Technology Agreement

Pursuant to Information and Communications Technology Agreement:

- (i) China Netcom System Integration (and its subsidiaries) provides information and communications technology services to China Netcom Group (and its subsidiaries (other than the Group)), which include the system integration services, software development services, operational maintenance services, consultancy services, equipment leasing-related services and product sales and distribution related services.
- (ii) China Netcom System Integration will also subcontract services ancillary to the provision of information communication 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 the PRC.



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The charges payable for the services provided under the Information and Communications Technology Agreement, are determined with reference to the following pricing principles and limits:

- (i) The government fixed price;
- (ii) Where there is no government fixed price but a government guidance price exists, the government guidance price; or
- (iii) Where there is neither a government price nor a government guidance price, the market price.

In relation to the charges payable for the services provided under the Information and Communications Technology Agreement that are to be determined with reference to the market price:

- (a) If the value of any single item of system installation and configuration services provided by China Netcom Group (and its subsidiaries) to China Netcom System Integration (and its subsidiaries) exceeds RMB0.3 million, the award of such services will be subject to tender; or
- (b) If the value of any single item of system integration, software development, operational maintenance, consultancy and equipment leasing-related services exceeds RMB0.5 million, or where the value of any single item of product sales and distribution related services exceeds RMB2 million, the award of such services will be subject to tender.

Continuing connected transactions relating to Asia Netcom

Capacity Purchase Agreement

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

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

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

Capacity Lease Agreement

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

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



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

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

Management Services Agreement

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

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

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

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

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

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

- (A) have received the approval of the Company's board of directors;
- (B) were carried out in accordance with the pricing policy as stated on pages 58 to 63 of this report;
- (C) have been entered into in accordance with the relevant agreements governing the Continuing Connected Transactions; and
- (D) have not exceeded their respective upper limits set by the The Stock Exchange of Hong Kong Limited ("**Hong Kong Stock Exchange**") for the financial year ended December 31, 2006.



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Directors

The directors for this financial year are:

Executive Directors

Zhang Chunjiang	
Zuo Xunsheng	(appointed on May 17, 2006)
Zhang Xiaotie	
Miao Jianhua	
Jiang Weiping	(resigned on May 17, 2006)

Non-executive Directors

Tian Suning	(re-designated as a non-executive director on May 17, 2006)
Li Liming	
Yan Yixun	
José María Álvarez-Pallete	
Mauricio Sartorius	(appointed on December 19, 2006, ceased to be the alternate director to Mr. José María Álvarez-Pallete on December 19, 2006)

Independent Non-executive Directors

John Lawson Thornton
Victor Cha Mou Zing
Qian Yingyi
Hou Ziqiang
Timpson Chung Shui Ming

Alternate Director

Hong Chen Jin	(appointed on December 19, 2006)
(alternate to Mr. José María Álvarez-Pallete and Mauricio Sartorius)	

Notes:

- (a) *Mr. Li Fushen was appointed as an Executive Director of the Company on January 15, 2007.*
- (b) *Ms. Li Liming resigned from her position as a Non-Executive Director on January 15, 2007.*

In accordance with Article 99 of the Company's Articles of Association, Dr. Qian Yingyi, Mr. Hou Ziqiang, Mr. Yan Yixun, and Mr. Timpson Chung Shui Ming will retire by rotation at the forthcoming annual general meeting of the Company and, being eligible, offer themselves for re-election. In accordance with Article 103 of the Company's Articles of Association, Mr. Zuo Xunsheng, Mr. Li Fushen and Mr. Mauricio Sartorius will also retire at the forthcoming annual general meeting and, being eligible, offer themselves for re-election.

The biographical details of the directors proposed for re-election at the forthcoming annual general meeting ("**Directors for Re-election**") are set out on pages 16 to 20. Except as disclosed in such biographical details, the Directors for Re-election have not held any other directorships in any listed public companies in the last three years. Further, except as noted in the biographical details, none of the Directors for Re-election is connected with any directors, senior management or substantial or controlling shareholders of the Company and, except for the share

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options granted to the Directors for Re-election (other than Dr. Qian Yingyi, Mr. Hou Ziqiang, Mr. Timpson Chung Shui Ming and Mr. Mauricio Sartorius) as set out in the paragraph "Share option scheme" below, none of them has any interests in the shares of the Company within the meaning of Part XV of the Securities and Futures Ordinance ("SFO").

The service contracts for Mr. Zuo Xunsheng and for Mr. Li Fusheng do not provide for a specified length of services. Dr. Qian Yingyi, Mr. Hou Ziqiang, Mr. Yan Yixun, Mr. Timpson Chung Shui Ming and Mr. Mauricio Sartorius have not entered into any service contract with the Company. Each of the Directors for Re-election will be subject to retirement by rotation and re-election at annual general meetings of the Company at least every three years. Each of such directors (other than Executive Directors and all Non-Executive Directors nominated by China Netcom Group) is entitled to an annual director's fee of HK\$200,000 as proposed by the board of directors and approved by the shareholders of the Company at the extraordinary general meeting held on February 14, 2007. Director's fees are payable on a time pro-rata basis for any non full year's service. Such directors shall also be entitled to an additional fee of HK\$10,000 for each Board meeting which such directors attend. In addition, Dr. Qian Yingyi is entitled to an additional annual fee of HK\$220,000 as a member of the Audit Committee, the Nominating and Corporate Governance Committee and the Strategy Committee and the chairman of the Compensation Committee, Mr. Hou Ziqiang is entitled to an additional annual fee of HK\$150,000 as a member of the Audit Committee, the Strategy Committee and the Supervision Committee and Mr. Timpson Chung Shui Ming is entitled to an additional annual fee of HK\$170,000 as the chairman of the Audit Committee, a member of the Compensation Committee and the Supervision Committee. Such directors shall also be entitled to an additional fee of HK\$5,000 for each committee meeting which such directors attend. In addition, for the financial year ended December 31, 2006, Mr. Zuo Xunsheng and Mr. Li Fusheng received annual basic salary of RMB290,000 and RMB 261,000, respectively, plus a discretionary bonus and a discretionary award of share options as determined by the Board with respect to the directors' performance. The remuneration of these directors has been determined with reference to the individual's duties, responsibilities and experience, and to prevailing market conditions.

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

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

Directors' interests in contracts

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

Directors' interest in competing businesses

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

Mr. Zhang Chunjiang, the Company's executive director and Dr. Tian Suning, the Company's non-executive director, have served as directors of PCCW Limited since April 1, 2005. Mr. José María Álvarez-Pallete is a Director of the following companies: Telefónica S.A., Telefónica Internacional, S.A, Telecomunicações de Sao Paulo, S.A. (listed on the Stock Exchanges of Sao Paulo and New York), Compañía de Telecomunicaciones de Chile, S.A. (listed on the Stock Exchanges of Santiago de Chile and New York), Telefónica de España, Telefónica Móviles S.A. (listed on the Stock Exchanges of Madrid and New York), Telefónica Móviles España, Telefónica Data, Telefónica Internacional, Telefónica de Argentina (listed on the Stock Exchanges of Buenos Aires and New York), Telefónica CTC Chile, Telefónica de Perú S.A.A. (listed on the Stock Exchange of Lima), Compañía de Teléfonos de Chile Transmisiones Regionales, Telefónica Larga Distancia de Puerto Rico, eslep



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and Cointel. In addition, he is a member of the Supervisory Board of Cesky Telecom (a company listed on the Stock Exchange of Prague). Mr. Mauricio Sartorius became the Chief Representative Officer of Asia of Telefónica Internacional on January 1, 2005. Ms. Hong Chen Jin has been an alternate director to both Mr. José María Álvarez-Pallete and Mr. Mauricio Sartorius since December 19, 2006 and was appointed deputy general manager of the Asia Representative Office of Telefónica Internacional in early 2005. Apart from the above, none of the directors of the Company is or was interested in any business, apart from the Company's business, that competes or competed or is or was likely to compete, either directly or indirectly, with the Company's business at any time during the 2006 financial year up to and including the date of this report.

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

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

Apart from those disclosed herein, as at December 31, 2006, none of the directors nor the chief executive of the Company had any interests or short positions in any of the shares, underlying shares or debentures of the Company or any of its associated corporations (within the meaning of the SFO) that is required to be recorded and kept in the register in accordance with section 352 of the SFO, any interests required to be notified to the Company and the Stock Exchange pursuant to the Model Code for Securities Transactions by Directors of Listed Issuers ("**Model Code**").

Emolument policy

The emolument policy of the Company has always been operation-centred and performance-oriented, in order to provide the support for the achievement of the Company's strategic objectives and promote the Company's long-term development. Employees are remunerated with a combination of a fixed salary, a performance-based salary and a long-term incentive scheme in the form of a share option scheme for eligible employees, details of which can be found in the paragraph "Share option scheme" below.

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

Each of Mr. Zhang Chunjiang, Mr. Zuo Xunsheng, Mr. Zhang Xiaotie, Mr. Miao Jianhua and Dr. Tian Suning (all of them being existing directors of the Company) and Ms. Li Liming and Mr. Jiang Weiping (being former directors of the Company) have voluntarily waived their entitlement to directors' fees for the years of 2005 and 2006. The total waived director's fees for the years of 2005 and 2006 amount to RMB1.666 million and RMB1.526 million respectively.

Employee retirement benefits

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

Share option scheme

The shareholders of the Company passed a resolution on September 30, 2004 to approve and adopt the share option scheme (the "**Share Option Scheme**"). On December 6, 2005, the Board convened a meeting and made minor amendments to the Share Option Scheme. The shareholders of the Company passed a resolution at an extraordinary general meeting held on May 16, 2006 to approve certain changes to the rules of Share Option Scheme so that the benefits to the grantees under the Share Option Scheme are closely aligned to the performance of the Company and the individual grantees.



Report of the Directors

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

(a) Purpose of the Share Option Scheme

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

(b) Participants of the Share Option Scheme

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

- (i) The directors (including executive directors and non-executive directors but not independent non-executive directors);
- (ii) Members of the middle-to-senior management; and
- (iii) Such class of “specialised professionals” identified by the Compensation Committee.

For the purpose of sub-paragraph (b)(iii) above, “specialised professionals” means such professionals or management staff or technical or marketing staff holding important positions that are important to the development of the Group’s business. The Compensation Committee has the right to interpret “specialised professionals” and identify them.

(c) Maximum number of shares and effective options

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

(d) As at the latest practicable date prior to the printing of this report, the total number of securities available for issue under the Share Option Scheme is 176,193,900, representing 2.65% of the issued share capital of the Company as at that date.

(e) Maximum entitlement of each participant

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



Report of the Directors

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

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

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

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

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

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

(i) Consideration

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

(j) The remaining life of the Share Option Scheme

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

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

- (i) The Board of the Company may amend any of the provisions of the Share Option Scheme and the terms of the options at any time.
- (ii) Any alterations to the matters set out in the Listing Rules and alterations which are to the advantage of existing or future grantees of options shall only be made with the approval of shareholders at general meeting.
- (iii) Any alterations to the terms and conditions of the Share Option Scheme which are of a material nature shall be approved by the shareholders of the Company at general meeting, except where the alterations take effect automatically under the existing terms of the Share Option Scheme.
- (iv) Any change to the authority of the Board in relation to alteration of the terms of the Share Option Scheme shall be approved by shareholders of the Company at general meeting. The amended Share Option Scheme or the terms thereof shall comply with the relevant requirements of the Listing Rules.
- (v) During the effective term of the Share Option Scheme, the Board may at any time terminate the Share Option Scheme or decide not to grant any options under the Share Option Scheme, and in such event the options granted under this Scheme (to the extent not already exercised) may still be exercisable pursuant to the rules of the Share Option Scheme or may be cancelled by the Board pursuant to rules thereof.
- (vi) The Share Option Scheme will be terminated upon the expiry of its effective term and any new share option scheme to be adopted by the Board shall be approved by the shareholders of the Company at general meeting.

Report of the Directors

The Company has granted share options under the Share Option Scheme prior to its listing on the Hong Kong Stock Exchange and on December 6, 2005. The shareholders of the Company also passed a resolution at an extraordinary general meeting held on May 16, 2006 to approve the relevant amendments to the terms of share options granted to reflect the amended rules of the Share Option Scheme.

As at December 31, 2006, the directors, chief executive and employees of the Company had the following personal interests in options to subscribe for shares of the Company granted under the Share Option Scheme.

	No. of shares involved in the options outstanding at the beginning of the year	No. of shares involved in the options outstanding at the end of the year	Date of the grant of the options	No. of shares involved in the options cancelled during the year	No. of shares acquired on exercise of options during the year	Price per share payable for the exercise of the options (HK\$)
Directors						
Zhang Chunjiang	920,000	920,000	October 22, 2004	—	—	8.40
Zuo Xunsheng	800,000	480,000	October 22, 2004	—	320,000	8.40
Zhang Xiaotie	800,000	480,000	October 22, 2004	—	320,000	8.40
Miao Jianhua	700,000	420,000	October 22, 2004	—	280,000	8.40
Tian Suning	920,000	920,000	October 22, 2004	—	—	8.40
Li Liming	700,000	420,000	October 22, 2004	—	280,000	8.40
Yan Yixun	590,000*	354,000	October 22, 2004	—	236,000	8.40
(1) Employees and other persons granted with options after the date of listing of the Company's shares on the Hong Kong Stock Exchange	79,320,000	79,034,200	December 6, 2005	285,800	—	12.45
(2) Employees and other persons granted with options before the date of listing of the Company's shares on the Hong Kong Stock Exchange	151,273,000*	93,618,700	October 22, 2004	1,975,800	55,678,500	8.40
Total	236,023,000	176,646,900		2,261,600	57,114,500	

Notes:

* Mr. Yan Yixun has made a commitment that all after-tax proceeds from the sale of shares acquired on the exercise of his options will be donated to the disadvantaged groups in society and people and groups in need of donation.

** The number of shares involved in the options outstanding at the beginning of the year included the share options granted to Mr. Jiang Weiping involving a total of 700,000 shares. Mr. Jiang Weiping resigned as executive director of the Company on May 17, 2006, and he continues to serve as the general manager of the human resources department of the Company.



Report of the Directors

- (a) The total number of shares involved in the options outstanding represents 2.65 per cent. of the issued share capital of the Company as at the latest practicable date prior to the printing of this report.
- (b) Grantees of the share options granted on October 22, 2004 are entitled to exercise the options in the following periods:
- (i) in respect of 40 per cent. of the options granted, from May 17, 2006 to November 16, 2010;
 - (ii) in respect of a further 20 per cent. of the options granted, from May 17, 2007 to November 16, 2010;
 - (iii) in respect of a further 20 per cent. of the options granted, from May 17, 2008 to November 16, 2010; and
 - (iv) In respect of the remaining 20 per cent. of the options granted, from May 17, 2009 to November 16, 2010.
- (c) Grantees of the share options granted on December 6, 2005 are entitled to exercise the options in the following periods:
- (i) in respect of 40 per cent. of the options granted, from December 6, 2007 to December 5, 2011;
 - (ii) in respect of a further 20 per cent. of the options granted, from December 6, 2008 to December 5, 2011;
 - (iii) in respect of a further 20 per cent. of the options granted, from December 6, 2009 to December 5, 2011; and
 - (iv) In respect of the remaining 20 per cent. of the options granted, from December 6, 2010 to December 5, 2011.
- (d) During the year ended December 31, 2006, no share option was granted by the Company under the Share Option Scheme.

Details of share options exercised during the period:

Period during which options were exercised	Exercise price (HK\$)	Weighted average closing price per share immediately before dates of exercise of options (HK\$)	Proceeds received (HK\$)	Number of shares involved in the options
From May 17, 2006 to December 29, 2006	8.40	14.46	479,761,800	57,114,500

Apart from the foregoing, at no time during the year ended December 31, 2006 was the Company, any of its holding companies or subsidiaries or fellow subsidiaries, a party for any arrangement to enable the directors or senior management of the Company or any of their spouses or children under eighteen years of age to acquire benefits by means of the acquisition of shares in or debentures of the Company or any other body corporate.



Report of the Directors

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

The Company has been notified of the following interests in the Company's issued shares as at December 31, 2006 amounting to 5 per cent. or more of the ordinary shares in issue:

	Number of ordinary shares interested		Percentage of total issued share capital (%)
	directly	indirectly	
China Network Communications Group Corporation	—	4,945,148,000 ⁽¹⁾⁽²⁾	74.36%
China Netcom Group Corporation (BVI) Limited	4,647,449,014 ⁽¹⁾	297,698,986 ⁽¹⁾⁽²⁾	74.36%
AllianceBernstein L.P.	—	332,783,700	5.00%

Notes:

(1) *China Network Communications Group Corporation ("China Netcom Group") beneficially owns 4,647,449,014 shares held by its wholly owned subsidiary, China Netcom Group Corporation (BVI) Limited ("CNC BVI") and 1 share held by CNC Cayman, Limited, a wholly owned subsidiary of CNC BVI. The percentage of total issued share capital beneficially held by China Netcom Group is 69.88%.*

(2) *China Netcom Group is deemed under the SFO to be interested in 297,698,985 shares held by CNC BVI as trustee on behalf of certain shareholders.*

Apart from the foregoing, as at December 31, 2006 no person or corporation had any interest in 5 per cent. or more of or any short position in the issued share capital of the Company as recorded in the registers required to be kept under section 336 of the SFO.

Public Float

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



Report of the Directors

Auditors

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

By order of the board

ZHANG Chunjiang
Chairman

Hong Kong, April 2, 2007