

Overview

The telecommunications industry in China is subject to extensive government regulation. A number of central government authorities have regulatory responsibilities for various aspects of the telecommunications industry. These authorities primarily include:

- The MII, which is responsible for, among other things:
 - formulating and enforcing industry policies and regulations as well as technical standards;
 - granting telecommunications service licenses;
 - supervising the operations and quality of service of telecommunications service providers;
 - allocating and administering telecommunications resources such as spectrum and numbers;
 - together with other relevant regulatory authorities, formulating tariff standards for telecommunications services;
 - formulating interconnection and settlement arrangements between telecommunications networks; and
 - maintaining fair and orderly market competition among service providers.
- Provincial communications administrations under the MII, which oversee the implementation of the Ministry's regulations and exercise regulatory authorities delegated by the Ministry within their respective provinces.
- The SDPC, which, together with the MII, sets government guidance tariffs for certain telecommunications services. The actual tariffs charged by providers of telecommunications services are determined by provincial communications administrations, together with the price bureaus of the provinces, autonomous regions or centrally administered municipalities where those providers operate. See the Section headed "Tariff Setting" below. It also approves investment and finance projects exceeding certain capital expenditure amounts as well as foreign investment projects exceeding certain investment amounts.

In order to provide a uniform regulatory framework to encourage the orderly development of the telecommunications industry, the Chinese government is in the process of drafting a telecommunications law. We expect that, if and when the telecommunications law is adopted by the Standing Committee of the National People's Congress, the highest state legislative body in China, it will become the basic telecommunications statute and provide a regulatory framework for the telecommunications industry in China.

Telecommunications Regulations

China's State Council promulgated the Telecommunications Regulations, which became effective as of September 25, 2000. The Telecommunications Regulations are substantially consistent with, and are primarily intended to streamline and clarify, the existing rules and policies for the telecommunications industry. They provide the primary regulatory framework for China's telecommunications industry in the interim period prior to the finalization and adoption of the telecommunications law.

The Telecommunications Regulations are intended to develop a transparent and fair regulatory environment to encourage fair and orderly competition and development in the telecommunications industry. The Telecommunications Regulations address all key aspects of telecommunications operations, including, among others, entry into the telecommunications industry, network interconnection, telecommunications resource allocation, tariffs and service standards.

Licensing

The Telecommunications Regulations adopt the existing regulatory distinction between basic and value-added telecommunications services. Basic telecommunications services include wireline local and domestic long distance telephone services, international telecommunications services, mobile communications services, satellite communications services, Internet backbone and other data network transmission services, and lease or sale of network elements. Value-added telecommunications services include value-added services provided over wireline telephone networks (e.g., telephone information, call center, voice mail and video conferencing services), value-added services provided over mobile networks, value-added services provided over Internet networks (e.g., Internet data center and Internet access and content services) and value-added services provided over other data networks (e.g., computer information, e-mail and electronic data interchange services). Providers of any basic telecommunications services as well as providers of value-added services in two or more provinces in China must apply for licenses from the Ministry of Information Industry. In accordance with the approval of the MII, we derive our exclusive rights to operate our businesses from our status as a subsidiary controlled by China Telecommunications Corporation, which holds the licenses required for operating our telecommunications businesses.

The State Council has promulgated the Administrative Regulations on Telecommunications Companies with Foreign Investment, which became effective on January 1, 2002. According to those regulations, enterprises with foreign investment may operate basic and value-added telecommunications businesses subject to the approval of the Ministry of Information Industry and MOFTEC. Certain limitations have been placed on the registered capital of, and maximum foreign shareholdings in, such enterprises.

The table below summarizes the foreign ownership and geographic restrictions for telecommunications joint ventures in China:

**Foreign Ownership Percentage and Geographic Restrictions
for Foreign-Invested Telecommunications Enterprises**

Sector	As of December 31,					
	2001	2002	2003	2004	2005	2006
Wireline				25% (3 cities) ⁽¹⁾		35% (17 cities) ⁽²⁾
Mobile	25% (3 cities) ⁽¹⁾	35% (17 cities) ⁽²⁾		49% (17 cities) ⁽²⁾		49% (nationwide)
Value-added	30% (3 cities) ⁽¹⁾	49% (17 cities) ⁽²⁾	50% (nationwide)			
Paging	30% (3 cities) ⁽¹⁾	49% (17 cities) ⁽²⁾	50% (nationwide)			

- (1) The initial three cities are Beijing, Shanghai and Guangzhou.
- (2) The 17 cities are Beijing, Chengdu, Chongqing, Dalian, Fuzhou, Guangzhou, Hangzhou, Nanjing, Ningbo, Qingdao, Shanghai, Shenyang, Shenzhen, Xiamen, Xi'an, Taiyuan and Wuhan.

The MII has promulgated the Measures on Administration of Telecommunication Business Licenses, which became effective on January 1, 2002. Those regulations apply to the application for, and examination and approval of, telecommunications business licenses in China.

Tariff Setting

The levels and categorization of most of our current tariffs are subject to regulation by various government authorities, including the MII, the SDPC, and, at the local level, the relevant provincial communications administrations and price bureaus. Under the Telecommunications Regulations, telecommunications tariffs are categorized into government fixed tariffs, government guidance tariffs and market based tariffs.

Currently, the monthly fee and usage fee for wireline local telephones services are determined by the relevant provincial communications administrations and provincial price bureaus, based on a guidance tariff range set by the MII in consultation with the SDPC. Tariffs for all domestic and international long distance service using public switched telephone networks, leased lines and basic services are fixed jointly by the MII and the SDPC. Tariffs for telecommunications services in respect of which effective competition has already developed, as determined by the MII according to the market conditions, may be set by the service providers. We derive a substantial portion (in excess of 70%) of our revenues from services that are subject to government guidance tariffs and government fixed tariffs. Currently, the MII allow tariffs for VoIP, Internet access services and certain value-added services provided over wireline telephone networks, such as telephone information, caller identification, voice mail and video conferencing services, to be set by service providers.

There is uncertainty with respect to how the Ministry of Information Industry would make a determination regarding effective competition as the MII has not publicly disclosed the criteria it uses for determining whether a certain type of service should be subject to market based tariffs. Under the Telecommunications Regulations, cost should be the primary basis for tariff setting, but the tariff level should also take into account social and economic development, the development of the telecommunications industry and consumers' ability to afford the services. The MII has not provided a timetable for tariff deregulation or indicated that service providers will eventually be permitted to freely set all tariffs.

Over the past few years, the Chinese government has adjusted the tariffs for telecommunications services, including the elimination of connection fees in July 2001. See the section headed "Business — Wireline Telephone Services." In general, we expect these adjustments to stimulate the overall usage of our telecommunications services. We also expect that increased flexibility in setting certain tariffs will allow us to better respond to changes in market demand and competitive conditions. For a discussion on the impact of these adjustments on our financial condition and results of operations, see the Section headed "Financial Information—General—Tariff Adjustments."

The Chinese government retains the ultimate authority to adopt changes to tariffs. However, the Telecommunications Regulations require the government to hold public

hearings before setting or changing mandatory or guidance tariff rates, which are attended by, among others, telecommunications operators and consumers. Recently, the Ministry of Information Industry has indicated that it does not intend to initiate any adjustment to tariffs for wireline local telephone services during the next three to five years. See the Section headed “Risk Factors—Risks Relating to the Telecommunications Industry in the PRC—Our revenues may be adversely affected by reductions in tariffs mandated by the Chinese government.”

Interconnection

Under the Telecommunications Regulations and the Administrative Rules on Interconnection between the Public Telecommunications Networks promulgated by the Ministry of Information Industry in May 2001, major telecommunications operators in China cannot refuse requests for interconnection and must enter into interconnection agreements upon request by other service providers. Interconnection agreements must be filed with the Ministry of Information Industry. Interconnection agreements may not be terminated unilaterally without prior approval by the Ministry of Information Industry.

The Telecommunications Regulations further provide that the technical standards and settlement methods for network interconnections be formulated by the Ministry of Information Industry. The Rules on the Settlement of Communication Fees between Telecommunications Networks promulgated by the Ministry of Information Industry in March 2001 provide in detail revenue sharing methods and settlement mechanisms between telecommunications network operators. Such revenue sharing methods are reviewed by the government periodically. In accordance with these regulations, China Telecom Group has entered into various interconnection agreements with other telecommunications service providers, including China Mobile, China Unicom and China Railcom.

The following table sets forth selected interconnection revenue sharing and settlement arrangements for local calls before and after the regulatory adjustment in 2001:

Network from Which Calls Originated	Network At Which Calls Terminated	Old Settlement Arrangement	New Settlement Arrangement
Mobile network	Wireline local network	(1) Mobile operator collects the cellular usage charge from its subscribers (2) Mobile operator pays RMB0.05 per minute to wireline operator	(1) Mobile operator collects the cellular usage charge from its subscribers (2) Mobile operator pays RMB0.06 per minute to wireline operator
Wireline local network	Mobile network	No revenue sharing or settlement	No revenue sharing or settlement

REGULATION

The following table sets forth selected interconnection revenue sharing and settlement arrangements for public switched telephone network domestic long distance calls before and after the regulatory adjustment in 2001:

Network From Which Calls Originated	Network At Which Calls Terminated	Old Settlement Arrangement	New Settlement Arrangement
Wireline or mobile at area A	Wireline or mobile network at area B, through the long distance network of operator C	<ol style="list-style-type: none"> (1) RMB0.14 per minute for operator at area A, the rest of the long distance tariff for operator C (2) No settlement between operator C and operator on the terminating end at area B 	RMB0.06 per minute for operator A, RMB0.06 per minute for operator B, the rest of the long distance tariff for operator C

The following table sets forth selected interconnection revenue sharing and settlement arrangements for VoIP domestic long distance calls before and after the regulatory adjustment in 2001:

Network From Which Calls Originated	Network At Which Calls Terminated	Old Settlement Arrangement	New Settlement Arrangement
Wireline local or mobile network at area A	Wireline local or mobile network at area B through the VoIP network of operator C	No revenue sharing or settlement	<ol style="list-style-type: none"> (1) Operator C collects the VoIP long distance charges from its subscribers (2) Operator C pays RMB0.06 per minute to operator B on the terminating end (3) No settlement between operator C and operator A on the originating end

Technical Standards

The Ministry of Information Industry sets industry technical standards for telecommunications terminal and interconnection-related equipment used in the public telecommunications networks. A network access license from the Ministry of Information Industry and other relevant regulatory authorities is required for all such equipment. Most of the standards set by the Ministry of Information Industry conform to standards recommended by the International Telecommunications Union and other international telecommunications standards organizations.

Capital Investment

To ensure the orderly development of telecommunications infrastructure and services, the State Council authorizes the MII to approve any plan to establish a nationwide telecommunications network or a network involving a total capital investment of RMB50 million to RMB200 million. The State Council also authorizes the SDPC and the SETC, to exercise responsibility over the approval of specific aspects of such investment projects. Any investment project with total capital investment in excess of RMB200 million must obtain approval from the State Council.

Telecommunications Resources

The MII is responsible for the administration and allocation of telecommunications resources in China, including radio frequencies and telecommunications network numbers. The use of these resources by telecommunications service providers is subject to the approval of the Ministry of Information Industry or the relevant provincial communications administrations and a usage fee payable to the Chinese government. However, the standards for usage fees of telecommunications network numbers have not yet been stipulated and it is not clear when telecommunications service providers, including us, will be required to pay such fees.

Quality of Service

Under the Telecommunications Regulations, the Ministry of Information Industry and the relevant provincial communications administration have the responsibility of supervising and monitoring the quality of services provided by telecommunications service providers in China. Under the Telecommunications Regulations, customers of telecommunications service providers have the right to submit their complaints to the Ministry of Information Industry and the relevant provincial communications administration or other relevant government authorities.

Universal Services

Under the Telecommunications Regulations, telecommunications service providers in China are required to fulfill universal service obligations in accordance with relevant regulations to be promulgated by the Chinese government, and the Ministry of Information Industry has been given authority by the Chinese government to delineate the scope of its universal service obligations. The Ministry of Information Industry may also select universal service providers through a tendering process. The Ministry of Information Industry, together with government finance and pricing authorities, is also responsible for formulating administrative rules relating to the establishment of a universal service fund and compensation schemes for universal services. These rules have not yet been promulgated and there are currently no specific regulatory requirements relating to the provision of universal services in China.