



Dear Shareholders,

Whilst 2005 was not an easy year for us, it was a year when hope was on the horizon. In spite of intensifying competition, we managed to achieve sustained business growth through strategic transformation. Our revenue increased by 6.4%, of which revenue from growth businesses (Internet access and value-added services) rose by 37.6%, accounting for 17.1% of our operating revenue. More importantly, I am very encouraged to see our people at all levels are now very committed to finding new ways of delighting our customers and creating value for them. This is crucial to the successful execution of our strategic transformation. I am fully confident in our sustainable future growth and enhancing value to you, as shareholders.

CHAIRMAN'S STATEMENT

The Company's financial performance in 2005 was favourable, with operating revenue reaching RMB169,310 million, of which amortisation of upfront connection fees was RMB6,781 million. Excluding the upfront connection fees, our operating revenue was RMB162,529 million, an increase of 6.4% from 2004; EBITDA¹ was RMB81,825 million, an increase of 4.2%; EBITDA margin¹ was 50.3%; profit attributable to equity holders of the Company¹ was RMB21,131 million, an increase of 8.0% from 2004; earnings per share¹ was RMB0.26. Capital expenditure was effectively controlled, and decreased by 4.3% from 2004. Free cash flow² reached RMB21,801 million.

Having considered the need to maintain the capital flexibility for ensuring the sustainable development of the Company and availability of capital for future development of our business, the Board of Directors will recommend in the upcoming shareholders general meeting that dividend be increased and a final dividend equivalent to HK\$0.075 per share be declared, representing an increase of 15.4% from 2004.

In 2005, our business developed steadily and our customer base progressively expanded. The number of local telephone subscribers reached 210 million, a net increase of 23.45 million from 2004. The number of broadband subscribers reached 21.02 million, a net increase of 7.19 million from 2004, representing our third consecutive year-on-year increase. Our revenue structure has been further optimised, and value-added services achieved a record high in revenue reaching nearly RMB10.0 billion, contributing to a growth in operating revenue (excluding amortisation of upfront connection fees) by 2.5 percentage points from 2004.

Our Company was confronted with severe challenges in 2005, when the value of telecommunications services began to shift from telephony to information services and enterprise customers' business capabilities enabled by telecommunications. Faced with this new situation, the Company adhered to its business tenet of continuously increasing its corporate value. By the end of 2004, we proposed the idea of strategic transformation, and by mid-2005, we had finalised the corresponding plan. While we reinforced the horizontal integration of multi-networks, multi-terminals and multi-services, we also emphasized the vertical extension of the value chain, and closely followed the shift in value. By leveraging the effective development of our traditional wireline telecommunications business, we were able to intensively explore business models for our emerging services and concentrate our efforts on the development of integrated information services, so as to cultivate the new core competitive strength of the Company.

In 2005, the varieties of our products were continuously enhanced, and new areas of value creation were discovered. We launched many new services based on the intelligent upgrading of wireline network and endeavored to prolong the life cycle of voice products. We also enriched both the function and content of value-added services, such as "SMS over PHS" and "Color Ring Tone", thereby accelerating the development of these value-added services. We formulated comprehensive and customised Information Communication and Technology (ICT) solutions for enterprise customers in key industries, and actively developed new global businesses to enable

¹ Including the amortisation of upfront connection fees, EBITDA was RMB88,606 million, EBITDA margin was 52.3%, profit attributable to equity holders of the Company was RMB27,912 million and earnings per share was RMB0.34.

² Free cash flow is calculated from EBITDA (excluding amortisation of upfront connection fees) minus capital expenditure and income tax.

CHAIRMAN'S STATEMENT *(continued)*

us to create value for customers while consolidating our market for enterprise customers. As part of this strategic transformation, services such as "BizNavigator", an ICT service for enterprise customers and "Best Tone", an integrated information enquiry service, were successfully launched such that we were able to consolidate our traditional business while exploring new sources of revenue and, more importantly, laid a solid foundation for providing integrated communication and information services in future.

The Company optimised its resources allocation in 2005. We controlled our investment in traditional wireline networks and implemented the upgrading to intelligent networks across the board. The expansionary capital expenditure on PHS was compressed. We ensured proper investment in marketing and business transformation and controlled effectively on labour costs and administrative expenses, thereby enhancing the efficiency in utilising such costs. By issuing short-term commercial paper at a low interest rate in the Chinese capital markets, finance costs were effectively reduced. We further improved our remuneration system and enhanced our efforts in staff training, thereby facilitating the career development of our employees.

In 2005, precision management was implemented across the board. Front line departments were optimised by shifting from functional management to a more holistic focus on process management. Precision sales and marketing were strengthened, and sales channels were improved. Effective and scientific method of resources allocation was established to maximise the effectiveness of the performance appraisal-oriented system. The quality of capital planning and cash flow budgeting was upgraded, and our debt structure was continuously improved. IT system was further developed to unify our front-end database and the establishment of our customer relation management system was accelerated. Our operation supporting systems were consolidated and our back-end resources database was gradually improved.

We continuously improved our corporate governance and internal controls during the year. The Company held its annual general meeting in Hong Kong for the first time in 2005, with a view to building a more direct and effective communication channel with our shareholders. In 2005, we began to disclose our key operating data and certain financial data on a quarterly basis, thereby improving the transparency of the Company. In September 2005, a new session of the Board of Directors was elected and a Nomination Committee was newly formed. Additional independent directors were appointed so that independent directors account for one third of the members of the Board of Directors. An internationally renowned finance professional joined the Audit Committee. The role of independent directors was strengthened. In 2005, the Company continued to comply with requirements of the regulatory authorities and adhere to the best international practices so as to strengthen our internal control progressively, minimise corporate risk and enhance our standards of operation and management.

As a major telecommunications and information service provider in China, we have made proactive efforts to discharge our social responsibilities by contributing to the informationalisation of our community and the development of the national economy. We enthusiastically engaged in environmental protection projects. In 2005, we provided monetary support to the green landscaping project around the Three Gorges Reservoir peripheral area, handicapped children and those who were unable to attend school due to poverty. We also participated in setting up "School of Hope". We sponsored the "International Scheme for the Youth of China to Start up Businesses" in order to assist youngsters to start their way to be a successful entrepreneur.

Looking ahead, we are fully confident in our future. With the steady and rapid growth of the economy of China and burgeoning new technologies, customers demand will be increasingly generated and therefore provide an ample market for the Company's strategic transformation. Our highly innovative management team and well performed employees constitute abundant human resources for the transformation. Our growing customer base and solid financial strength provide us with an important safeguard in terms of our capacity to ensure our successful strategic transformation.

We shall adhere to the philosophy of co-opetition and proactively manage the changing demand and shifts in industry value, thereby creating a favourable business environment for the Company's development. We shall fully utilise new technologies to energise our traditional business. While enhancing the investment return on wireline network, we will also explore new growth areas to assure the sustainable growth of the Company. Through dynamic allocation of resources, we shall achieve a balanced development in both our traditional business and business for transformation. We shall reinforce the planning for our operations, marketing and network, get prepared to be a "Triple-player", offering voice, data and video services in future. Through the convergence of information service resources in our community, we shall make the utmost effort to expand room for new growth. By leveraging our advantage on network resources and distribution channel, we shall strengthen our leading position in the value chain of integrated information services and endeavor to be the forerunner in the field of integrated communication and information services.

Finally, on behalf of the Board of Directors of the Company, I would like to thank Mr. Cheng Xiyuan and Mr. Feng Xiong for their dedication and hard work during their offices as directors of the Company, and at the same time I welcome Mr. Tse Hau Yin, Aloysius and Mr. Xu Erming to join the Board of Directors of the Company. I also take this opportunity to express my sincere appreciation to all of our shareholders, directors and the members of the Supervisory Committee as well as our employees and customers.



Wang Xiaochu
Chairman and Chief Executive Officer

Beijing, PRC
22 March 2006



An aerial photograph of terraced rice fields, showing a series of green, stepped terraces carved into a hillside. The terraces are filled with lush green rice plants, and the edges are defined by earthen walls. The perspective is from a high angle, looking down at the terraces as they curve and descend the slope. The overall color is a vibrant green, with some brownish tones on the terraced edges.

A Well Developed Foundation