

## BUSINESS REVIEW

The following table sets out our key operating data in 2003, 2004 and 2005:

	Unit	2003	2004	2005	Change 2005 over 2004
Local wireline access lines					
in service	Thousand	160,988	186,648	<b>210,094</b>	12.6%
Local voice usage	Million pulses	384,496	429,150	<b>449,404</b>	4.7%
Domestic long distance usage	Million minutes	67,312	81,960	<b>93,817</b>	14.5%
International (including Hong Kong, Macau and Taiwan) long distance usage	Million minutes	1,670	1,654	<b>1,711</b>	3.4%
Broadband subscribers	Thousand	7,231	13,839	<b>21,024</b>	51.9%
2M digital circuits leased	Thousand	163.14	169.45	<b>197.42</b>	16.5%
Volume of inbound local calls	Million minutes	76,210	94,747	<b>102,670</b>	8.4%
Caller ID service subscribers	Thousand	82,461	109,031	<b>131,461</b>	20.6%
Telephone information service usage	Million minutes	1,743	2,419	<b>3,540</b>	46.3%
SMS Usage Volume	Million messages	—	—	<b>17,254</b>	—
Color Ring Tone subscribers	Thousand	—	—	<b>18,162</b>	—

In 2005, we steadily implemented our strategic transformation, moving forward from a traditional basic network operator to a modern integrated information services provider. While maintaining steady development of our traditional wireline voice services, we made great efforts in the strategic development of broadband service and “SMS over PHS”, Color Ring Tone and other mature value-added services (“VAS”) to extend our value chain. In our effort to develop business models for emerging services, we launched integrated services such as the “Best Tone”, “BizNavigator” and fixed line and PHS convergence (“FPC”). We also conducted overall planning for the Company, taking into account both the front end and back end in concert, which reinforced our competitive advantages in service quality and brand name image in the industry.

Our operating revenue in 2005 was RMB169,310 million, an increase of 5.0% from 2004. Excluding the amortisation of upfront connection fees, our operating revenue was RMB162,529 million, representing a 6.4% annual growth. In 2005, revenue from our local telephone services was slightly higher than that of previous year. Revenue from Internet access service and VAS grew rapidly, driving the overall operating revenue up by 5.0%.

## BUSINESS ANALYSIS

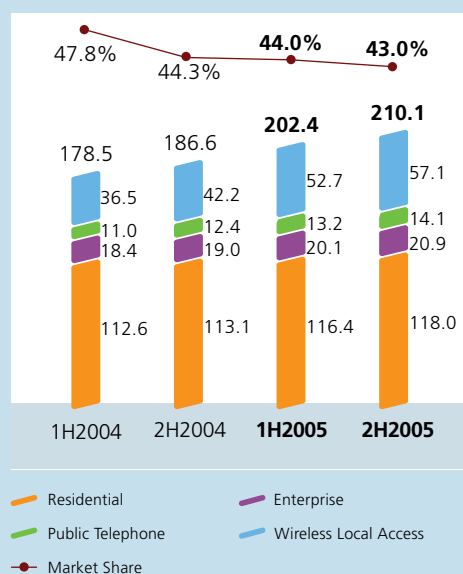
### Local telephone services

In 2005, as the gap between mobile phone tariffs and tariffs for wireless local access services narrowed, mobile substitution for wireline telephone subscribers and local usage exacerbated. To ensure steady development of our local telephone services, an important foundation of the Company, we effectively segmented our subscribers, launched diversified service packages, optimised our distribution channels and strengthened our agent channels and on-line channels, while focusing our effort on optimising the coverage of our wireless local access network at hot spots so as to improve our service quality. Revenue from local telephone services for 2005 amounted to RMB80,945 million, an increase of 0.8% from 2004, representing 49.8% of operating revenue (excluding the amortisation of upfront connection fees). Revenue from local usage fees was similar to that of 2004. Local voice usage amounted to 449,404 million pulses, indicating an annual growth of 4.7%.

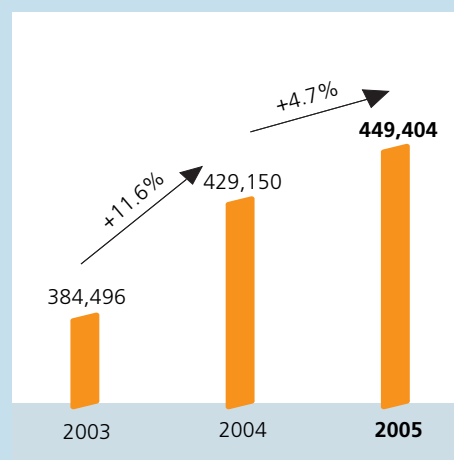
In 2005, our local telephone subscribers reached 210.09 million, and our market share for subscribers<sup>1</sup> was 43.0%, a decrease of 1.3 percentage points from 2004. Based on regional differences, we focused on newly constructed commercial buildings and residential communities in urban areas, towns and prosperous rural regions, reasonably allocated our resources and adopted a number of flexible ways for connection, sales and marketing, thereby rapidly penetrating the targeted market. As a result, net increase of rural residential subscribers in 2005 was 4.90 million, representing a growth rate of 8.8%.

At the same time, we continued to optimise our local wireless telephone network by adhering to our principle of effective coverage, so as to improve the network utilisation and service quality and lower sales costs. In 2005, wireless local access services grew steadily with a net increase of 14.91 million subscribers, an annual growth rate of 35.4%.

**Local Telephone Subscriber**  
(million)



**Local Voice Usage**  
(million pulses)

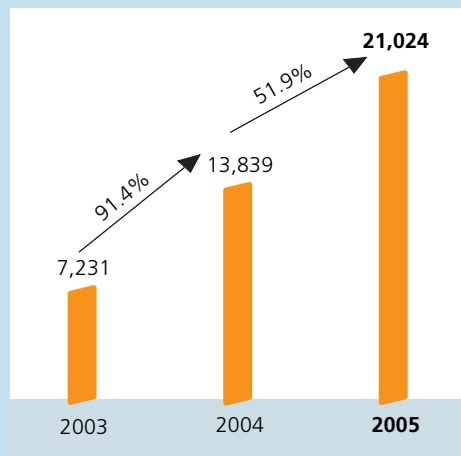


<sup>1</sup> Market share for subscribers is calculated by dividing local telephone subscribers of the Company by all of the wireline telephone subscribers and mobile telephone subscribers in the Company's service area, and based on statistical data from the Ministry of Information Industries ("MII") and the Company.

**BUSINESS REVIEW** *(continued)***Internet and VAS services**

In 2005, our Internet and VAS services grew rapidly. Revenue from Internet and VAS services reached RMB27,838 million, an increase of 37.6% from 2004, accounting for 17.1% of our operating revenue (excluding amortisation of upfront connection fees), which was 3.9 percentage points higher than in 2004.

Broadband service is our most valuable strategic operation and one of the major media for various information services and applications. In 2005, the Company continued to expand its broadband subscriber base to 21.02 million with a net increase of 7.19 million or a growth rate of 51.9%. At the same time, we speeded up our exploration on the bandwidth-based segmentation of broadband subscribers and provided differentiated services in terms of quality, application contents and prices. We also began to consolidate the authentication and the billing systems for broadband subscribers and proceed with simplifying the verification procedures for broadband access and multiple applications in order to improve our customers' experience and upgrade the product value of broadband access.

**Broadband Subscribers**  
(Thousand)

In 2005, revenue from caller ID, telephone information services and Internet VAS continued to experience fast growth. In addition, we made great efforts to promote the VAS on PHS, including "SMS over PHS" and "Color Ring Tone" services. We emphasized the economy of scale of these services and their packaging with traditional services. We strengthened our



"Short messaging services over PHS"

promotion of brand names via television advertisement and printed media. We also established our service provider management platform and cooperated extensively with content providers for SMS and "Color Ring Tone". As a result, the annual SMS usage volume amounted to 17,254 million messages and there were 18.16 million subscribers for the "Color Ring Tone" service.

### Long distance services

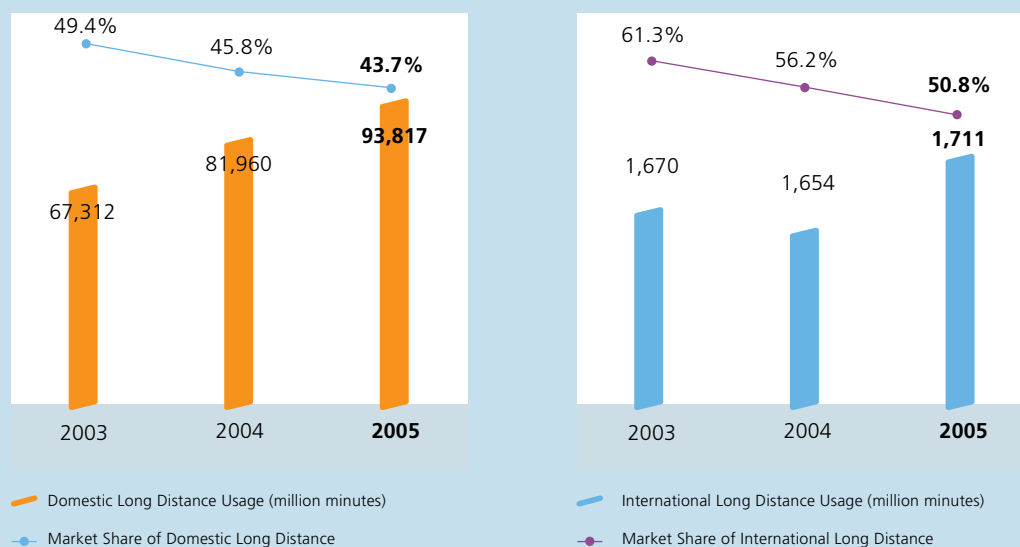
In 2005, revenue from domestic long distance services was RMB25,993 million, a slight decrease of 0.9% from 2004. On the principle of stabilising our market share, we responded quickly to market changes and launched various packages to meet the needs of subscribers from different segments in the market. We also increased our effort of promotion to lower the "perceived price" by subscribers and alleviate the increasing diversion of our long distance traffic. Our market share<sup>2</sup> for domestic long distance usage was stabilised with a decrease of 2.1 percentage points from 2004 to 43.7% in 2005. Our domestic long distance usage grew 14.5% to 93,817 million in 2005.

In 2005, competition in international and Hong Kong, Macau and Taiwan long distance telephone services was further intensified. Diversion to technologies such as Instant Message and IP telephony was more apparent. Revenue from international long distance services was RMB3,407 million, a decrease of 10.1% from 2004. Usage volume was 1,711 million minutes, an increase of 3.4% over 2004. Market share<sup>2</sup> dropped by 5.4 percentage points from 2004 to 50.8%. In order to alleviate the declining trend, we launched a variety of marketing initiatives to address different customer segments, such as "familiarity numbers" package and

<sup>2</sup> Based on statistical data from the MII and the Company.

**BUSINESS REVIEW** *(continued)*

combination of broadband and IP services. We also took advantage of the government policy of "Supporting Overseas Expansion of the Enterprises in China" to enhance our marketing efforts to target PRC enterprises seeking overseas development, so as to stabilise our revenue from international, Hong Kong, Macau and Taiwan long distance telephone services.

**Managed data and leased line services**

In the wake of rapid informationalisation, we provided our corporate clients with integrated one-stop shopping solutions through system integration and network maintenance outsourcing service. We explored more thoroughly our customers' needs for IT service and expanded our market effectively. Revenue from managed data and leased line services was RMB7,422 million in 2005.

**Interconnection services**

In 2005, revenue from interconnection was RMB12,838 million, an increase of 19.8% from 2004, and net interconnection revenue was RMB7,365 million, an increase of 11.2% from 2004. As the number of mobile subscribers continued to grow rapidly, the volume of inbound local calls reached 102,670 million minutes, indicating an increase of 8.4% from 2004.

## PRODUCT DEVELOPMENT, SERVICES INNOVATION AND BRAND PROMOTION

In 2005, we achieved favorable results in the development of new products such as the integrated terminal and integrated services. In order to enhance the value for our traditional voice services, we developed FPC product, based on the principle of "terminal first and network next". In order to effectively expand the market for integrated information services, we launched "Best Tone", an integrated information enquiries service, and "BizNavigator", an ICT service for enterprise clients. We consolidated the public customer information services and the enterprise application services, and cooperated with both downstream and upstream enterprises, thereby achieving extension and expansion of the value chain of business lines and service lines.

We reinforced our image of quality service through customer service hotline "10000". We unified the customer-oriented interfaces and service standards, and gradually build up our competitive advantages in terms of customer friendliness and business handling capacity. We also further optimised our own sales channels and improved coordination among such channels, and enhanced the service standards of the business outlets. In addition, we strengthened our agency distribution channels and the role of online customer service centres.



"BizNavigator" - ICT for small & medium enterprises

In 2005, we established our unified brand name framework and development planning. Service brand names such as "Color Ring Tone" and "ChinaVnet" have already been well recognized. At the same time, we designed customer segment-oriented service portfolio brand names such as the "BizNavigator", and our framework for brand names has been evolving from constituting mainly service brand names to a blend of major service brand names and customer brand names.

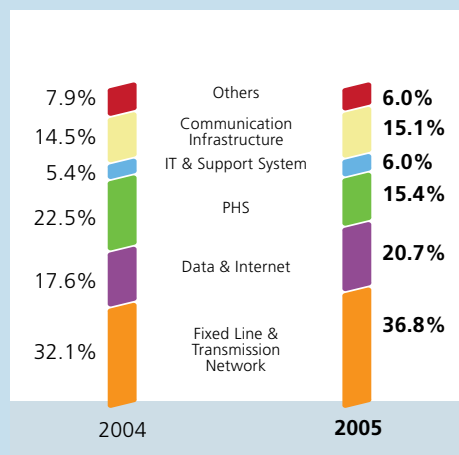
## BUSINESS REVIEW (continued)

## IMPLEMENTATION OF NETWORK UPGRADING TO SUPPORT OUR BUSINESS TRANSFORMATION

According to our established strategic deployment for our transformation, we took proactive efforts in materialising our network transformation in 2005. Driven by the needs of customers and technological advances, we speeded up the transformation of our existing network system to the next generation network. We endeavour to materialise the speedy deployment of network and services and the effective support to the integration of broadband and narrowband services, with a view to minimise the costs of services provision and network operations, and to provide our customers with differentiated network qualities and maintenance services. In 2005, we adhered to the principle of “high quality, high value-adding applications, high utilisation of resources, low churn rate and low subsidies”, and have seen great improvement in the operation of our wireless local access network. Network quality of the wireless local access network improved significantly by means of network optimisation. In 2005, we fully implemented the upgrade of wireline network to intelligent network, and thereby speeded up the introduction of the “softswitch” technology. As at the end of 2005, we had basically completed the network intelligence upgrade in 40% of our subsidiaries, 35% of our subsidiaries completed part of local network upgrade, and the remaining 25% of our subsidiaries were preparing for such upgrade. At present, in service areas where the upgrading of intelligent network has been completed, new businesses such as our wireline “Color Ring Tone”, prepaid services, “Unicode service”, wireline telephone number portability within local network, have gradually found popularity among our customers. We expect to complete all of our network upgrade by the end of 2006, thereby forming a centralised management platform for subscribers and enabling centralised management of wireline telephone subscribers, PHS subscribers and related services. These will lay a sound foundation for customer identification, tailored services and provision of inter-network integration services. In addition, we have also boosted IP-based Metropolitan Area Network (MAN) optimisation and broadband speeding up in order to improve our bandwidth supporting capability and support key businesses such as video services.

It is essential for our successful strategic transformation to optimise our capex structure and improve investment efficiency. In 2005, we continuously adjusted and optimised our investment structure and balanced the proportion between expansionary investment and maintenance investment, and between strategic investment and recurring investment, thereby achieving

## CAPEX Composition



effective interaction between investment, network capacity and market demand and service provisioning capabilities. We continuously increased our investment in broadband and VAS, IT support system, the intelligent upgrading of wireline network and network coverage in rural areas, of which the proportion of investment in the data network and Internet increased by approximately 3.1 percentage points from last year. Investment in wireless local access service has been under control, the investment proportion of which dropped by 7.1 percentage points from 2004. Such investments have enabled continued, profitable growth of traditional fixed line service, and provided more privileges to investment in key networks, services and geographical areas, which have ensured fast growth of core services and products and satisfied the strategic demand for network capabilities.

## 2006 BUSINESS OUTLOOK

In 2006, we will continue with our subscriber base development and retention of existing subscribers and usage. We will allocate our resources in a more rational way and adopt various cooperation models to penetrate newly constructed residential communities in urban areas and more profitable rural markets. We will ensure that our wireless local access network be optimised in areas where the usage volume is high, increase the in-door coverage, and promote FPC service and other widely accepted service packages. With these measures, we will ensure a steady growth of our traditional voice service. We will also promote broadband services in a more differentiated way and enrich terminal functions and applications to accelerate its growth. Based on the intelligent upgrading of network, we will enrich personalised applications such as "SMS over PHS" and "Color Ring Tone". At the same time, we will push forward the healthy development of VAS, speed up the promotion of transformation services featuring "BizNavigator" and "Best Tone", and establish a flexible joint marketing mechanism. By so doing, we will firmly establish our leading position in the field of comprehensive information services.



"Best Tone" – Voice search engine







A vibrant field of yellow rapeseed flowers in full bloom, stretching across rolling hills. In the background, a line of tall, dark evergreen trees stands against a clear, bright blue sky. The foreground is filled with the dense, bright yellow of the flower heads, with some green leaves visible. The overall scene conveys a sense of natural growth and vitality.

# Stimulating Growth