



Our People – Xia Li

↑ 33%

Free cash flow sharply increased by 33%  
to RMB29.1 billion



*We aim to provide our services in the most efficient way, which is essential for enhancing shareholder value. Riding on our way to full services operation, we strictly control expenditure with resources allocation skewed towards growth businesses while generating more free cash flow for our shareholder return and future investment for full services convergence offering to deliver profitable growth.*

# Management's Discussion and Analysis of Financial Conditions and Results of Operations

## SUMMARY

The Company's operating revenues in 2006 were RMB175,093 million, an increase of 3.4% from 2005. Operating expenses were RMB136,483 million, an increase of 4.7% from 2005; profit attributable to equity holders of the Company was RMB27,142 million, and basic earnings per share were RMB0.34. EBITDA<sup>1</sup> was RMB89,882 million and EBITDA margin was 51.3%.

Excluding amortisation of upfront connection fees of RMB4,971 million, our operating revenues in 2006 were RMB170,122 million, an increase of 4.7% from 2005; profit attributable to equity holders of the Company was RMB22,171 million; basic earnings per share were RMB0.27. EBITDA<sup>1</sup> was RMB84,911 million and EBITDA margin was 49.9%.

## OPERATING REVENUES

The Company's operating revenues in 2006 were RMB175,093 million, an increase of 3.4% from 2005. Excluding the amortisation of upfront connection fees, operating revenues in 2006 were RMB170,122 million, an increase of RMB7,593 million or 4.7% from 2005. In which, revenue from Internet access services, value-added services, and interconnection increased by RMB5,768 million, RMB4,157 million and RMB1,257 million respectively from 2005, represented the major sources of operating revenues growth. Revenue from managed data increased by 2.5% from 2005; revenues from leased line and other services remained at similar level as 2005. Revenues from local telephone services and long distance services decreased generally.

<sup>1</sup> Our EBITDA refers to profit before net finance costs, investment income, share of profit from associates, income tax, depreciation and amortisation, deficit on revaluation of property, plant and equipment (if applicable) and minority interests. As the telecommunications business is a capital intensive industry, capital expenditure, the level of gearing and finance costs may have a significant impact on the net profit of companies with similar operating results. Therefore, we believe EBITDA may be helpful in analysing the operating results of a telecommunications service provider like us. Although EBITDA has been widely applied in the global telecommunications industry as a benchmark to reflect the operating performance, financial capability and liquidity, it is not regarded as a measure of operating performance and liquidity under generally accepted accounting principles. It also does not represent net cash from operating activities. In addition, our EBITDA may not be comparable to similar indicators provided by other companies.

The following table sets forth a breakdown of operating revenues in 2005 and 2006, together with their respective rates of change:

For the year ended 31 December			
(RMB in millions, except percentage data)			
	2006	2005	Rate of Change
Wireline telephone services <sup>2</sup>			
Local			
Installation fees	2,913	2,970	(1.9)%
Monthly fees	28,973	30,351	(4.5)%
Local usage fees	46,188	47,624	(3.0)%
Subtotal	78,074	80,945	(3.5)%
Domestic long distance <sup>3</sup>	25,517	25,993	(1.8)%
International, Hong Kong, Macau and Taiwan long distance <sup>3</sup>	3,140	3,407	(7.8)%
Interconnections	14,095	12,838	9.8%
Subtotal	42,752	42,238	1.2%
Internet access services	23,630	17,862	32.3%
Value-added services	14,133	9,976	41.7%
Managed data	3,031	2,958	2.5%
Leased line services and others <sup>4</sup>	8,502	8,550	(0.6)%
Operating revenues (excluding amortisation of upfront connection fees)	170,122	162,529	4.7%
Upfront connection fees	4,971	6,781	(26.7)%
Total operating revenues	175,093	169,310	3.4%

<sup>2</sup> Including revenue from our registered subscribers, public telephones and pre-paid calling cards services.

<sup>3</sup> Including revenue from VoIP long distance services.

<sup>4</sup> Including primarily revenue from other domestic telecommunications operators and business customers for the lease of wireline telecommunications network facilities, sales and repairs and maintenance of customer-end equipment and construction of telecommunications network and infrastructure for customers.

## LOCAL TELEPHONE SERVICES

Revenue from our local telephone services decreased by 3.5% from RMB80,945 million in 2005 to RMB78,074 million in 2006, representing 44.6% of our total operating revenues, or 45.9% of operating revenue excluding the amortisation of upfront connection fees. The major reason for the decrease in revenue was that the declining tariffs for mobile telephone services has narrowed the gap between mobile service tariffs and wireline service tariffs, mobile operations further exacerbated the diversion from wireline services, causing a drop in our local voice ARPU.

# Management's Discussion and Analysis of Financial Conditions and Results of Operations

**Installation fees** Upfront installation fees is amortised over the expected customer relationship period of 10 years. Revenue from amortisation of upfront installation fees decreased by 1.9% from RMB2,970 million in 2005 to RMB2,913 million in 2006.

**Monthly fees** Revenue from monthly fees decreased by RMB1,378 million, or 4.5%, from RMB30,351 million in 2005 to RMB28,973 million in 2006.

**Local usage fees** Revenue from local usage fees in 2006 was RMB46,188 million, a decrease of RMB1,436 million or 3.0%, from 2005. Local voice usage volume decreased by 6.0% from 2005 to 422,562 million pulses in 2006, due to the intensifying mobile substitution and the diversification of the means of communication.

## LONG DISTANCE TELEPHONE SERVICES

Revenue from the Company's long distance telephone services decreased by 2.5% from RMB29,400 million in 2005 to RMB28,657 million in 2006, representing 16.4% of total operating revenues, or 16.8% of operating revenues excluding amortisation of upfront connection fees.

**Domestic long distance services** In 2006, revenue from domestic long distance services was RMB25,517 million, decreased by 1.8% from RMB25,993 million in 2005, while domestic long distance telephone usage volume increased by 1.9% from 93,817 million minutes in 2005 to 95,567 million minutes in 2006. The decrease in revenue was attributable to a decrease in average unit price, which decreased from RMB0.28 per minute in 2005 to RMB0.27 per minute in 2006.

**International, Hong Kong, Macau and Taiwan long distance services** International, Hong Kong, Macau and Taiwan long distance services revenue decreased by 7.8% from RMB3,407 million in 2005 to RMB3,140 million in 2006. Average unit price of international, Hong Kong, Macau and Taiwan long distance services was RMB1.96 per minute in 2006 which represented a slight decrease from RMB1.99 per minute in 2005. The decrease in revenue was mainly attributable to a decrease in the usage volume, which decreased by 6.4% from 2005.

## INTERCONNECTION SERVICES

Revenue from interconnection services increased by 9.8% from RMB12,838 million in 2005 to RMB14,095 million in 2006, representing 8.1% of our total operating revenues, or 8.3% of operating revenues excluding amortisation of upfront connection fees. The growth was mainly attributable to an increase in interconnection volume resulting from the growth of the domestic telecommunications services subscriber base and the traffic volume expansion in the telecommunications market.

## INTERNET ACCESS SERVICES

Revenue from Internet access services grew by 32.3% from RMB17,862 million in 2005 to RMB23,630 million in 2006, representing 13.5% of the total operating revenues, or 13.9% of operating revenues excluding amortisation of upfront connection fees. Driven by the continuous expansion of our broadband subscriber base in recent years, our Internet access services revenue sustained a rapid growth. The number of broadband subscribers increased by 34.7%, or 7.30 million to 28.32 million as of the end of 2006 when compared to the end of 2005.

## VALUE-ADDED SERVICES

Revenue from value-added services grew by 41.7% from RMB9,976 million in 2005 to RMB14,133 million in 2006, representing 8.1% of our total operating revenues, or 8.3% of operating revenues excluding amortisation of upfront connection fees. The increase in revenue from value-added services was mainly attributable to the rapid development of comprehensive information application services, SMS, caller ID service, colour ring tone and telephone information services.

## MANAGED DATA SERVICES

Revenue from managed data services increased by 2.5% from RMB2,958 million in 2005 to RMB3,031 million in 2006. The growth in revenue was mainly attributable to the increased demand of subscribers for network resources.



## LEASED LINE AND OTHER SERVICES

Revenue from leased line and other services decreased by 0.6% from RMB8,550 million in 2005 to RMB8,502 million in 2006. In which, revenue from leased line services grew by 0.9% from RMB4,464 million in 2005 to RMB4,503 million in 2006.

## UPFRONT CONNECTION FEES

Upfront connection fees represent the amortised amount of the upfront fees received for the initial activation of the Company's wireline services, amortised over the expected customer relationship period of 10 years. Effective from July 2001, the Company ceased to charge new subscribers upfront connection fees. The amortised amount decreased by 26.7% from RMB6,781 million in 2005 to RMB4,971 million in 2006.

The table below sets forth the amortisation of upfront connection fees for each year from 2007 to 2011 based on the calculation of amortisation over the 10-year estimated amortisation period (with 2011 as the end of the amortisation period):

	For the year ended 31 December				
	2007	2008	2009	2010	2011
	(RMB in millions)				
Amortisation of upfront connection fees	3,295	2,022	1,151	497	98

## OPERATING EXPENSES

In 2006, our operating expenses were RMB136,483 million, an increase of 4.7% from 2005. The ratio of our operating expenses to total operating revenues increased from 77.0% in 2005

to 77.9%, and the ratio of operating expenses to operating revenues excluding amortisation of upfront connection fees was 80.2%, unchanged from 2005. The following table sets out a breakdown of our operating expenses in 2005 and 2006 and their respective rates of change:

	For the year ended 31 December		
	(RMB in millions, except percentage data)		
	2006	2005	Rate of Change
Depreciation and amortisation	51,272	49,652	3.3%
Network operations and support expenses	30,723	30,334	1.3%
Selling, general and administrative expenses	22,214	19,892	11.7%
Personnel expenses	26,019	24,960	4.2%
Interconnection and other operating expenses	6,255	5,518	13.4%
Total operating expenses	136,483	130,356	4.7%

**Depreciation and amortisation** Depreciation and amortisation expenses were RMB51,272 million in 2006, an increase of 3.3% from 2005, representing 29.3% of our total operating revenues. The depreciation and amortisation expenses as a

percentage of our operating revenues excluding amortisation of upfront connection fees decreased from 30.5% in 2005 to 30.1% in 2006.

# Management's Discussion and Analysis of Financial Conditions and Results of Operations

**Network operations and support expenses** Network operations and support expenses increased by 1.3% from RMB30,334 million in 2005 to RMB30,723 million in 2006, representing 17.5% of our total operating revenues. The network operations and support expenses as a percentage to operating revenues excluding amortisation of upfront connection fees decreased from 18.7% in 2005 to 18.1% in 2006.

**Selling, general and administrative expenses** In 2006, selling, general and administrative expenses amounted to RMB22,214 million, an increase of 11.7% from RMB19,892 million in 2005, representing 12.7% of our total operating revenues. Selling, general and administrative expenses as a percentage of operating revenues excluding amortisation of upfront connection fees increased from 12.2% in 2005 to 13.1% in 2006. This increase was mainly attributable to additional efforts in retaining and expanding our subscriber base, and improving the promotion of business branding and customer branding in order to bring these in line with our strategic transformation, and also additional expenses for product research and development.

**Personnel expenses** In 2006, personnel expenses were RMB26,019 million, an increase of 4.2% from RMB24,960 million in 2005, or 0.5 percentage points below the growth rate of operating revenues excluding amortisation of upfront connection fees. Our personnel expenses accounted for 14.9% of our total operating revenues, or 15.3% of operating revenues excluding amortisation of upfront connection fees, which is similar to that in 2005. The increase in personnel expenses was mainly attributable to the maintenance of an effective incentive system for employees.

**Interconnection and other operating expenses** The Company's interconnection and other operating expenses increased by 13.4% from RMB5,518 million in 2005 to RMB6,255 million in 2006. The growth in long distance voice interconnections and the SMS interconnections constituted most of the increase in interconnection expenses. The net revenue from interconnections (interconnection revenue less interconnection expenses) amounted to RMB7,883 million, an increase of 7.0% from 2005.

## NET FINANCE COSTS

In 2006, the Company's net finance costs were RMB4,667 million, a decrease of RMB228 million or 4.7% from RMB4,895 million in 2005. Interest expenses decreased by RMB622 million. The decrease was attributable to the repayment of borrowings and reduction in average interest rate through various measures including the issue of short term commercial paper. However, net exchange gain in 2006 was RMB86 million, a decrease of RMB477 million from RMB563 million in 2005. The main reason for the decrease in net exchange gain was the decrease in magnitude of appreciation of Renminbi against US Dollar and Japanese Yen in 2006.

## INCOME TAX

The Company's statutory income tax rate is 33%. In 2006, the Company's income tax expenses were RMB6,754 million, and effective income tax rate was 19.9%, whereas the effective income tax rate excluding upfront connection fees was 23.3%. The difference between the effective income tax rate and the statutory income tax rate was mainly attributable to the exclusion of upfront connection fees from taxable income, and the preferential income tax rate of 15% enjoyed by our operating subsidiaries located in special economic zones and in the western part of China. Another reason for our effective tax rate being lower than the statutory tax rate was that some of the Company's operating subsidiaries received tax credits of RMB1,413 million on the purchases of domestic equipment in 2006.

## PROFIT ATTRIBUTABLE TO EQUITY HOLDERS OF THE COMPANY

In 2006, profit attributable to equity holders of the Company reached RMB27,142 million, a decrease of 2.8% from RMB27,912 million in 2005. Excluding amortisation of upfront connection fees, profit attributable to equity holders was RMB22,171 million, an increase of 4.9% from RMB21,131 million in 2005. The Company has maintained a good level of operating efficiency and profitability.

## CAPITAL EXPENDITURE

In 2006, the Company continued with its prudent policy on capital expenditure. The capital expenditure decreased by 8.9% from RMB53,864 million in 2005 to RMB49,085 million in 2006. In order to achieve the strategic transformation of the Company, we have effectively controlled the scale of capital expenditure and optimised its structure, with emphasis on significant reduction in capital expenditure on wireless local access service and the increase of investment in Internet access and data network.

In 2007, our estimated capital expenditure is RMB47,000 million. The main sources of our capital are cash generated from operating activities, bank borrowings and other indebtedness. We expect that we will have sufficient funding sources to meet our capital expenditure requirements in the future.

## CASH FLOWS AND CAPITAL RESOURCES

### Cash Flows

In 2006, net cash inflow of the Company was RMB3,070 million, while the net cash inflow was RMB1,656 million in 2005.

The following table sets out our cash flow position in 2005 and 2006:

	For the year ended 31 December	
	2006	2005
	(RMB in millions)	
Net cash flows from operating activities	<b>74,506</b>	68,359
Net cash used in investing activities	<b>(49,997)</b>	(51,894)
Net cash used in financing activities	<b>(21,439)</b>	(14,809)
Net increase in cash and cash equivalents	<b>3,070</b>	1,656

In 2006, the net cash flow from operating activities was RMB74,506 million, an increase of RMB6,147 million from RMB68,359 million in 2005. Increase in net cash from operating activities indicated the steady growth in the Company's business and an improvement in our effective cost control.

In 2006, we achieved saving in capital expenditure. Cash used in investing activities was RMB49,997 million, a decrease of RMB1,897 million from 2005.

In 2006, our net cash outflow in financing activities was RMB21,439 million, as compared with the net cash used of RMB14,809 million in 2005.

In April 2006, we raised RMB19,920 million in cash to meet the working capital requirement of our operations and reduce finance cost through the issue of short-term commercial paper due in one year with a nominal value of RMB20 billion. In addition, we continued to repay certain long-term borrowings in 2006, and net cash used in repaying such borrowings (the difference between the cash from borrowings and the cash used for repaying borrowings) increased from RMB9,046 million in 2005 to RMB14,969 million in 2006.



# Management's Discussion and Analysis of Financial Conditions and Results of Operations

## WORKING CAPITAL

By the end of 2006, the Company's working capital (total current assets minus total current liabilities) deficit was RMB117,012 million, a decrease of RMB3,301 million from the deficit of RMB120,313

million in 2005. The decrease in deficit was mainly attributable to the growth in cash and cash equivalents. By the end of 2006, the Company's cash and cash equivalents amounted to RMB18,191 million, of which 98.6% was denominated in Renminbi.

## INDEBTEDNESS

Our indebtedness analysis as of the end of 2005 and 2006 was as follows:

	As of 31 December	
	2006	2005
	(RMB in millions)	
Short-term debt	<b>79,516</b>	76,005
Long-term debt maturing within one year	<b>8,242</b>	8,963
Finance lease obligations maturing within one year	<b>48</b>	108
	<b>87,806</b>	85,076
Long-term debt (excluding current portion)	<b>37,257</b>	55,777
Finance lease obligations (excluding current portion)	<b>-</b>	52
	<b>-</b>	-
Total debt	<b>125,063</b>	140,905

By the end of 2006, the Company's total indebtedness was RMB125,063 million, a decrease of RMB15,842 million from 2005. The main reason for the decrease was the repayment of certain long-term borrowings.

Therefore, the ratio of the Company's total indebtedness to total assets decreased from 33.8% in 2005 to 30.2% in 2006. The Company believes that it has continued to maintain a solid capital structure.

Most of the Company's revenue receipts and payments made are denominated in Renminbi, and Renminbi is not a freely convertible currency. By the end of 2006, loans in Renminbi, Japanese Yen, US Dollar and Euro accounted for 96.5%, 1.6%, 1.1% and 0.7% of the Company's total indebtedness, respectively. 73.7% of our indebtedness was loans with fixed interest rates.

## CONTRACTUAL OBLIGATIONS

The following table sets out the Company's contractual obligations as of 31 December 2006:

	Total	2007	Payable in			
			2008	2009	2010	After 2010
			(RMB in millions)			
Short-term debt	79,516	79,516	–	–	–	–
Long-term debt	45,499	8,242	3,815	656	246	32,540
Finance lease obligations	48	48	–	–	–	–
Operating lease commitments	1,773	468	315	266	223	501
Capital commitments	3,402	3,402	–	–	–	–
Total contractual obligations	130,238	91,676	4,130	922	469	33,041