

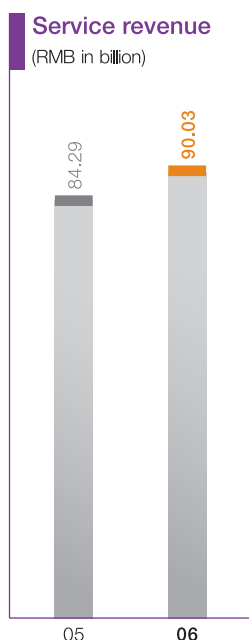
# Management's Discussion and Analysis of Financial Condition and Results of Operations

## I. Overview

In 2006, we continued to grow our business effectively. Our total revenue maintained steady growth and reached RMB94.29 billion by the end of 2006, up by 8.3% from 2005. Our profit for the year amounted to RMB3.73 billion. Excluding the effect of the RMB2.40 billion unrealised loss on changes in fair value of derivative component of Convertible Bonds at fair value, the profit for the year would increase by 24.3% from RMB4.93 billion in 2005 to RMB6.13 billion in 2006. Basic earnings per share in 2006 were RMB0.296. Excluding the effect of the RMB2.40 billion unrealised loss on changes in fair value of derivative component of Convertible Bonds, adjusted basic earnings per share in 2006 would be RMB0.486, up by 24.0% from 2005. Adjusted EBITDA was RMB31.69 billion in 2006.

We have maintained a sound balance sheet structure during the year as the liabilities-to-assets ratio (Note 3) decreased from 46.5% as at 31 December 2005 to 45.8% as at 31 December 2006. The capital expenditures for 2006 were RMB21.55 billion. Cash flow continued to improve. Free cash flow (i.e. net cash inflow from operating activities minus capital expenditures) increased from RMB13.19 billion in 2005 to RMB13.90 billion in 2006. Our net cash inflow from operating activities amounted to RMB35.45 billion, increased by 15.1% from 2005.

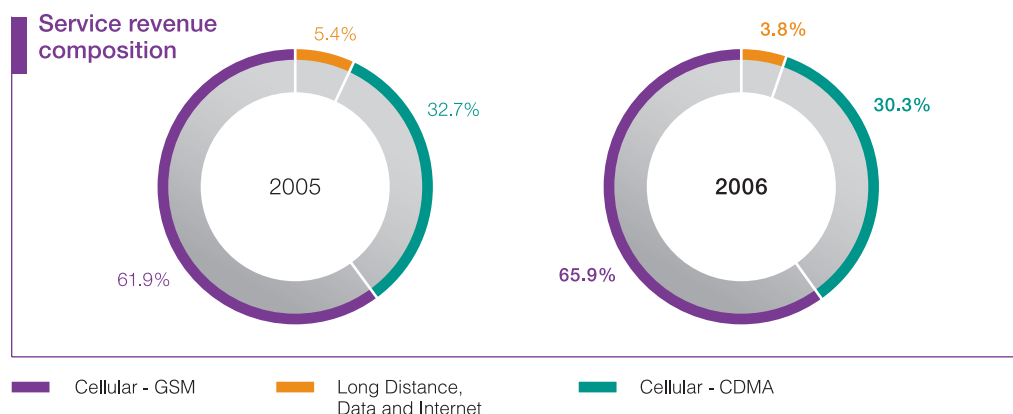
Note 3: Liabilities-to-assets ratio represents total liabilities over total assets.



## II. Revenue

Our revenue continued to grow steadily in 2006. The total revenue was RMB94.29 billion, up by 8.3% from 2005. Of the total revenue in 2006, our total service revenue was RMB90.03 billion, up by 6.8% from 2005, and revenue from the sales of telecommunications products was RMB4.27 billion, up by 54.5% from 2005.

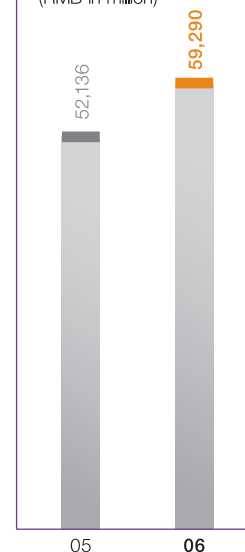
The table below sets forth the changes in service revenue composition and the percentage of total service revenue for each of our business segment for the years of 2005 and 2006:



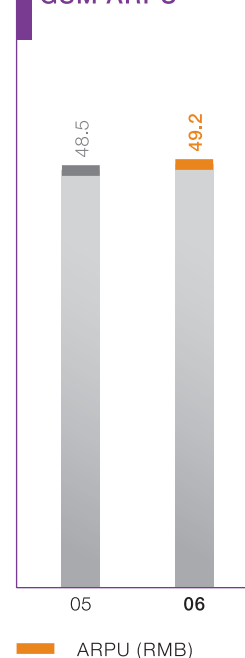
	2006		2005	
	RMB in million	As percentage of total service revenue	RMB in million	As percentage of total service revenue
Total service revenue	90,027	100.0%	84,287	100.0%
Include: Cellular	86,583	96.2%	79,713	94.6%
Of which: GSM	59,290	65.9%	52,136	61.9%
CDMA	27,293	30.3%	27,577	32.7%
Long Distance, Data and Internet	3,444	3.8%	4,574	5.4%

### Service revenue of GSM Cellular Business

(RMB in million)



### GSM ARPU



## 1. GSM Cellular Business

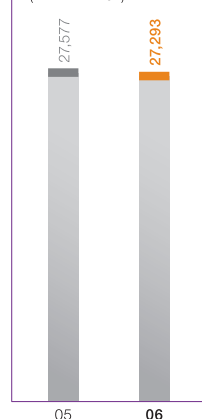
In 2006, we have maintained a continued growth in GSM Cellular Business. Revenue from our GSM Cellular Business increased by 13.7% from RMB52.14 billion in 2005 to RMB59.30 billion in 2006, of which service revenue accounted for RMB59.29 billion, also up by 13.7% from 2005. Such increase is mainly due to increase in the number of subscribers and in revenue from GSM value-added services. ARPU also increased from RMB48.5 in 2005 to RMB49.2 in 2006, up by RMB0.7. Sales of telecommunications products relating to our GSM Cellular Business was RMB8.17 million in 2006.

Revenue from GSM value-added services amounted to RMB11.54 billion in 2006, up by 44.9% from 2005. The share of revenue from GSM value-added services as a percentage of the GSM service revenue increased from 15.3% in 2005 to 19.5% in 2006 due to our efforts to strengthen the development and promotion of the value-added business.

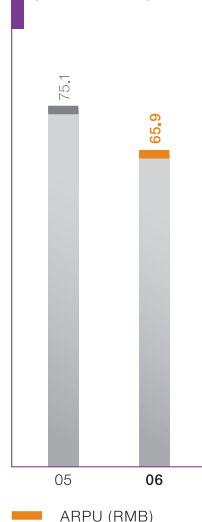
In line with the growth of the GSM Cellular Business and interconnection traffic volume, interconnection revenue from the GSM Business increased to RMB4.91 billion in 2006, up by 41.8% from 2005.

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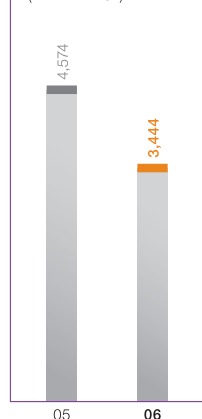
**Service revenue of CDMA Cellular Business**  
(RMB in million)



**CDMA ARPU**



**Service revenue of Long Distance, Data and Internet Business**  
(RMB in million)



## 2. CDMA Cellular Business

In 2006, we continued to emphasise an effective development on CDMA Cellular Business. Revenue from CDMA Cellular Business reached RMB31.55 billion, an increase of 4.1% from 2005. Of the total revenue from CDMA Cellular Business, service revenue was RMB27.29 billion and decreased by 1.0% from 2005 due to a decrease of the ARPU by RMB9.2 from RMB75.1 in 2005 to RMB65.9 in 2006. Such ARPU decrease was because certain high-end contractual customers did not renew their contracts upon expiry while the average ARPU of new customers was relatively lower. Sales of telecommunications products relating to our CDMA Cellular Business increased to RMB4.26 billion, up by 55.2% from 2005.

We continued to utilise the technical advantages of CDMA1X technology to improve our revenue from CDMA value-added services. Such revenue reached RMB5.31 billion in 2006, up by 29.1% from 2005, and accounted for 19.5% of the service revenue from CDMA Cellular Business in 2006, an increase from 14.9% in 2005. Of the service revenue from CDMA Cellular Business, revenue from CDMA1X data business was RMB1.99 billion, representing an increase of 49.2% from 2005 and accounting for 37.5% of the value-added service revenue from CDMA Cellular Business in 2006.

In line with the growth of CDMA Cellular Business and interconnection traffic volume, interconnection revenue from CDMA Cellular Business reached RMB1.73 billion by the end of 2006, up by 23.9% from 2005.

## 3. Long Distance, Data and Internet Business

Tariff for traditional businesses such as outgoing long distance calls continued to decrease due to intensive market competition. To address this, we adjusted our business structure and dropped less profitable products. In 2006, our service revenue from Long Distance, Data and Internet Business was RMB3.44 billion, down by 24.7% from 2005 due to a decrease of 3.4% of the total minutes of outgoing domestic and international calls from 2005.

### III. Costs and Expenses

In 2006, we strengthened expense control and total costs and expenses were RMB87.80 billion. Excluding the effect of the RMB2.40 billion unrealised loss on changes in fair value of derivative component of Convertible Bonds, costs and expenses would be RMB85.40 billion, increase by 6.8% from 2005, which is slower than the 8.3% growth in the total revenue in 2006.

The table below illustrates the major cost items from 2005 and 2006 and their respective share of service revenue:

	2006		2005	
	RMB in million	As percentage of service revenue	RMB in million	As percentage of service revenue
Total costs and expenses	87,799	97.5%	79,947	94.9%
Leased lines and network capacities	8,763	9.7%	8,747	10.4%
Interconnection charges	9,595	10.7%	8,372	9.9%
Depreciation and amortisation	22,423	24.9%	20,368	24.2%
Employee benefit expenses	6,649	7.4%	5,616	6.7%
Selling and marketing	19,252	21.4%	20,558	24.4%
General, administrative and other expenses	13,416	14.9%	11,742	13.9%
Finance costs, net of interest income	395	0.4%	1,003	1.2%
Cost of telecommunications products sold	4,930	5.5%	3,575	4.2%
Unrealised loss on changes in fair value of derivative component of Convertible Bonds	2,397	2.7%	—	—
Other gains-net	(21)	(0.1%)	(35)	—

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## Analysis of costs and expenses

Percentage of costs and expenses to service revenue (%)



### 1. Leased lines and network capacities

Our aggregate lease expense for leased lines and network capacities reached RMB8.76 billion in 2006, up by 0.2% from 2005, and as a percentage of the service revenue decreased from 10.4% in 2005 to 9.7% in 2006. Under the connected party transactions agreement, lease expense for the CDMA network capacity in 2006 was calculated based on 30% of the business income from our CDMA Cellular Business in 2006. Network capacity lease expense for the CDMA Cellular Business for year 2006 increased from RMB7.92 billion in 2005 to RMB8.08 billion in 2006.

### 2. Interconnection charges

Due to the increase in interconnection traffic volume, interconnection charges increased to RMB9.60 billion in 2006, up by 14.6% from 2005. Interconnection charges as a percentage of the service revenue increased from 9.9% in 2005 to 10.7% in 2006. Net interconnection charges from 2006 was RMB2.43 billion, down by 18.1% from 2005, and accounted for 2.7% of the service revenue in 2006 as opposed to 3.5% in 2005.

### 3. Depreciation and amortisation

Depreciation and amortisation expenses increased by 10.1% from RMB20.37 billion in 2005 to RMB22.42 billion in 2006 and, as a percentage of the service revenue, increased from 24.2% in 2005 to 24.9% in 2006.

### 4. Employee benefit expenses

In 2006, due to various factors including a general increase in the employee insurance premium expenditure, recruitment of new staff for business expansion and increase of share-based compensation costs from the grant of new share options under the share option scheme in 2006, employee benefit expenses for the year increased to RMB6.65 billion, up by 18.4% from 2005, and represented 7.4% of the service revenue, up from 6.7% in 2005.

### 5. Selling and marketing

In 2006, due to our effective cost control measures, particularly on the customer acquisition costs on contractual CDMA subscribers and commission expenses, selling and marketing expenses totaled RMB19.25 billion in 2006, a decrease of 6.4% from 2005. Such selling and marketing expenses accounted for 21.4% of our service revenue in 2006, down by 3.0% from 24.4% in 2005. Amortisation of customer acquisition costs on contractual CDMA subscribers was RMB4.21 billion (2005: RMB5.95 billion) in 2006. The balance of unamortised CDMA customer acquisition costs decreased from RMB2.94 billion as of 31 December 2005 to RMB2.10 billion as of 31 December 2006.

## Analysis of costs and expenses

Composition of costs and expenses (%)



# including employee benefit expenses, finance costs, net of interest income, cost of telecommunications products sold, unrealised loss on changes in fair value of derivative component of Convertible Bonds and other gains-net

## 6. General, administrative and other expenses

Affected by factors such as increases in rents for base stations, maintenance fees, utilities charges and other expenses, general, administrative and other expenses increased by 14.3% from RMB11.74 billion in 2005 to RMB13.42 billion in 2006. General, administrative and other expenses as a percentage of the service revenue increased from 13.9% in 2005 to 14.9% in 2006.

## 7. Finance costs, net of interest income

In 2006, we further strengthened and improved our capital structure, centralised management and enforced effective application of our capital resources. As we improved our cash inflow from operating activities and improved our debt structure through the issuance of Convertible Bonds and short-term bonds, finance costs, net of interest income decreased from RMB1.00 billion in 2005 to RMB0.40 billion in 2006, down by 60.6%. In addition, we recorded an exchange gain of RMB0.37 billion due to the appreciation of RMB during 2006, which also contributed to the decrease of our finance costs.

## 8. Cost of telecommunications products sold

The cost of telecommunications products sold increased to RMB4.93 billion, up by 37.9% from 2005. This increase was primarily due to increases in the CDMA handsets units purchased and sold. The corresponding sales of telecommunications products was RMB4.27 billion, up by 54.5%. The net loss from the sales of telecommunications products was RMB0.66 billion, which is RMB0.15 billion less than the net loss in 2005.

## 9. Unrealised loss on changes in fair value of derivative component of Convertible Bonds

In July 2006, we issued the Convertible Bonds to SK Telecom, a mobile telecommunications service operator in Korea. In accordance with the requirements of Hong Kong Accounting Standard 39, "Financial Instruments — Recognition and Measurement", the bond contract must be separated into two components: a derivative component consisting of the conversion option and a liability component consisting of the straight debt element of the bond. The conversion option is carried at fair value on the balance sheet with any changes in fair value being charged or credited to the income statement in the period when the change occurs. The fair value of the derivative component of the Convertible Bond is calculated using the Binomial model, which considers various factors including exercise price, volatility, expected dividend yield,

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risk free rate, expected life of options and the closing price of our share at valuation date. Due to the substantial increase in our share price from HKD6.95 as at 5 July 2006, (the issuance date of the Convertible Bonds) to HKD11.40 as at 31 December 2006, the fair value of the derivative component in respect of the Convertible Bonds has increased and therefore resulted in an unrealised loss on changes in fair value of derivative component of Convertible Bonds of the RMB2.40 billion recognised in the income statement. The unrealised loss had no effect on our cash flows or other aspects of our operations in 2006.

## IV. Earnings

### 1. Profit before income tax

In 2006, our profit before income tax was RMB6.50 billion after the unrealised loss on changes in fair value of derivative component of Convertible Bonds of the RMB2.40 billion. Excluding the effect of the RMB2.40 billion unrealised loss on changes in fair value of derivative component of Convertible Bonds, our profit before income tax would be RMB8.89 billion, an increase of 25.2% from 2005.

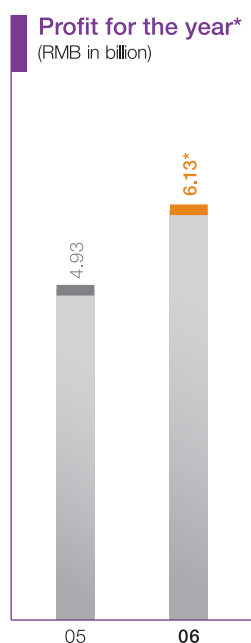
Profit before income tax for the GSM Cellular Business was RMB7.48 billion, up by 2.8% from 2005 as a result of the increase in revenue from GSM Cellular Business. Profit before income tax for the CDMA Cellular Business improved quarter on quarter and reached RMB1.06 billion. Profit before income tax for the Long Distance, Data and Internet Business was RMB0.49 billion after the Company focused on developing profitable businesses.

### 2. Income tax

Our income tax increased to RMB2.76 billion in 2006 and the effective tax rate in 2006 was 42.5%. Excluding the effect of the RMB2.40 billion unrealised loss on changes in fair value of derivative component of Convertible Bonds, the effective tax rate would be 31.1%, similar to 30.6% in 2005.

### 3. Profit for the year

Our profit for the year reached RMB3.73 billion in 2006. Basic earnings per share in 2006 were RMB0.296. Excluding the effect of the RMB2.40 billion unrealised loss on changes in fair value of derivative component of Convertible Bonds, the profit for the year would be RMB6.13 billion and the adjusted basic earnings per share would be RMB0.486, an increase of 24.0% from 2005.



\* Please refer to Note 1 and Note 2 of "Financial Highlights" as set out in page 4 for explanations.

## V. Adjusted EBITDA

Adjusted EBITDA was RMB31.69 billion in 2006 and adjusted EBITDA margin (Adjusted EBITDA as a percentage of the total revenue) was 33.6%.

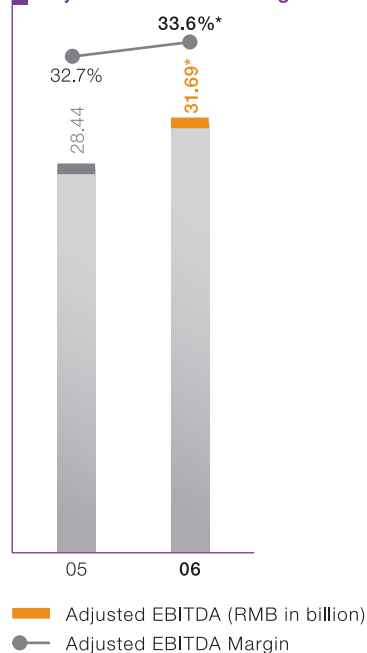
EBITDA for the GSM Cellular Business was RMB26.42 billion, up by 3.8% from 2005. EBITDA margin (EBITDA as a percentage of the total revenue) for the GSM Cellular Business decreased from 48.8% in 2005 to 44.6% in 2006 as a result of increased commission expenses under intensified competition environment and increased interconnection charges. EBITDA for the CDMA Cellular Business increased from RMB0.44 billion in 2005 to RMB1.82 billion in 2006 and the EBITDA margin for the CDMA Cellular Business increased from 1.4% in 2005 to 5.8% in 2006. EBITDA for the Long Distance, Data and Internet Business was RMB3.66 billion, an increase of 36.7% from 2005. EBITDA margin for the Long Distance, Data and Internet Business increased from 32.1% in 2005 to 44.6% in 2006.

## VI. Capital expenditures and free cash flow

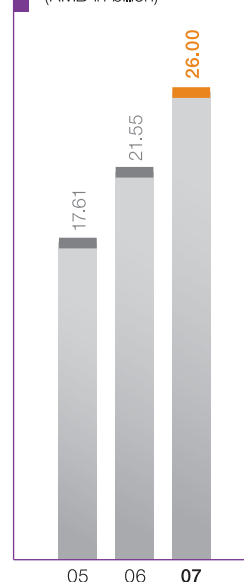
Our capital expenditures totaled RMB21.55 billion in 2006, representing an increase of 22.4% from RMB17.61 billion in 2005. Capital expenditures attributable to the GSM Cellular Business were RMB10.58 billion. Capital expenditures for the Long Distance, Data and Internet Business were RMB1.44 billion. Capital expenditures for local gateway and infrastructure network were RMB3.70 billion. Capital expenditures for billing system, customer services and information technology system and buildings and others were RMB5.83 billion.

Both cash inflow from operating activities and free cash flow continued to improve from RMB30.80 billion and RMB13.19 billion in 2005 to RMB35.45 billion and RMB13.90 billion in 2006, respectively. Cash inflow from operating activities increased by 15.1% from 2005.

Adjusted EBITDA\* and Adjusted EBITDA margin\*



Capital expenditures and projected capital expenditures  
(RMB in billion)





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The table below illustrates the capital expenditures of various major businesses in 2006 and the planned expenditures in 2007:

	2006	2007
	RMB in billion	RMB in billion
Total	21.55	<b>26.00</b>
GSM Cellular	10.58	<b>13.60</b>
Long Distance, Data and Internet	1.44	<b>1.00</b>
Gateway and infrastructure network	3.70	<b>3.90</b>
Others	5.83	<b>7.50</b>

Capital expenditures planned for 2007 are estimated RMB26.00 billion, capital expenditures for the GSM Cellular Business are estimated to be approximately RMB13.60 billion which will be used to satisfy customers' demand, improve the quality of network coverage and increase the network capacity as appropriate. Capital expenditures for the Long Distance, Data and Internet Business are estimated to be approximately RMB1.00 billion. Capital expenditures for local gateway and infrastructure network are estimated to be approximately RMB3.90 billion. Capital expenditures for information technology system and buildings and others are estimated to be approximately RMB7.50 billion.

We plan to rely primarily on cash generated from operating activities to satisfy our capital expenditures needs.

## VII. Balance Sheet

In 2006, our balance sheet structure was further improved. Total assets increased from RMB142.63 billion as of 31 December 2005 to RMB146.44 billion as of 31 December 2006. Total interest-bearing debts decreased from RMB34.58 billion as of 31 December 2005 to RMB25.65 billion as of 31 December 2006. The liabilities-to-assets ratio decreased from 46.5% as at 31 December 2005 to 45.8% as at 31 December 2006. The debt-to-capitalisation ratio (Note 4) decreased from 31.2% as at 31 December 2005 to 24.4% as at 31 December 2006.

As of 31 December 2006, we had net current liabilities (i.e. current assets minus current liabilities) of RMB29.88 billion, representing a decrease of RMB5.71 billion from RMB35.59 billion at the end of 2005. Taking into account of available sources of financing and continuous net cash inflows from operating activities, we believe that we have sufficient funds to meet our working capital requirements and debt obligations.

Note 4: Debt-to-capitalisation ratio represents interest bearing debts plus minority interest over interest bearing debts plus total equity.