

## Chief Executive Officer's Statement



### Dear Shareholders,

I am pleased to report to you that we made significant progress in 2006 toward our strategic goal of becoming a “broadband communications and multi-media service provider”, against the backdrop of escalating challenge from intensifying mobile substitution. Contribution of our high-growth businesses to the total revenue continued to increase, laying a solid foundation for our strategic transformation.

### 1. Stable Financial Performance

In 2006, the Company generated RMB87,901 million of consolidated revenues, which include RMB86,921 million of revenue from continuing operations and RMB980 million of revenue from discontinued operations. Excluding upfront connection fees of RMB2,406 million, our revenue was RMB85,495 million, of which RMB84,515 million was attributable to continuing operations. Revenue from continuing operations grew by 2.5% over the last year. Intensifying mobile substitution and a downward adjustment of tariff for inter-district calls slowed down our revenue growth in 2006 as compared with that of last year.

Our consolidated net profit for 2006 was RMB12,960 million, and excluding upfront connection fees, our consolidated net profit was RMB10,554 million which includes discontinued operations (unless otherwise specified, all data in the subsequent sections exclude discontinued operations and the effect of the upfront connection fees). As a result of our strengthened management over CAPEX, CAPEX for continuing operations for the year was RMB26,474 million, which was RMB826 million lower than the budgetary guidance outlined by management at the beginning of the year. Benefiting from revenue growth, cost control and effective capital expenditure management, our free cash flow\* grew by a robust 19.9% to RMB7,476 million.

As a result of the growth of free cash flow, by the end of 2006, our interest bearing debts reduced by 3.6% to RMB79,154 million.

\* Free cash flow represents net cash flow from operating activities of continuing operation net of capital expenditure

### 2. Challenges Faced by Traditional Fixed-line Businesses

2006 was an unusual year for monolithic telecommunications operators in China which solely operate fixed-line networks. The acceleration of mobile substitution created severe imbalances in the competitive landscape. Our traditional fixed-line business was facing acute challenges.

In 2006, our strategic response to the acceleration of mobile substitution was to leverage off our extensive network resources and the multi-business nature of our business to develop bundled and converged services. In the first half of 2006, the Company launched a bundled service offered under the brand “Family 1+”, and a converged service offered under the brand “Unified Number” which captures both fixed-line and mobile functionalities in certain cities. This helped to lessen mobile substitution to a certain extent in the pilot cities. By the end of 2006, the number of local telephone subscribers amounted to 114.934 million, reporting a decline for the first time in our corporate history. Of the subscribers, 27.334 million were PHS subscribers, almost at the same level as over the same period last year. Both the local voice ARPU and traffic experienced a decline.

In 2006, we launched several new products targeted at a variety of market segments. These included: the “Family 1+” bundled product for urban residential customers; the “Economical Phone” service which does not charge monthly



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fees for rural customers; and the "New Sunshine" service for colleges and universities. We believe with the completion of upgrading of our local fixed network to embrace intelligent functionalities and the implementation of our initiatives to retain our traditional fixed line business through bundled services, we will be able to lessen effects of mobile substitution in 2007 and to defend our dominant market position in the traditional fixed line market of our northern service region.

### 3. Sustained Rapid Development of High-growth Businesses

In 2006, we experienced continued strong momentum in high-growth services including broadband service, value-added services, information and communications technology (ICT) and business & data communications services. This sector experienced revenue increase of 31.6% from last year, reaching 26.0% of the total revenue, up 5.8 percentage points from last year. High-growth businesses helped offset revenue decline in traditional fixed line businesses and was the biggest drive for sustainable and effective growth in 2006.

The Company's strategy for high-growth businesses in 2006 included promoting broadband video and interactive content and applications while expanding the broadband subscriber base; continuously launching new value-added services; and speeding up the promotion of "CNC Connected" and ICT business to make them the growth drivers in the future. Such strategies achieved sound results in 2006.

Broadband service still experienced rapid growth. As at the end of 2006, we had 15.081 million broadband subscribers, representing an increase of 31.4% from last year. Through the implementation of strategic initiatives such as broadband applications and content, IPTV and broadband business, we are gradually entering into a new business model for broadband operation, with an "access + content" combined fee mechanism riding on a "PC + TV" multi-terminal platform. By the end of 2006, revenue attributable to broadband and Internet-related services amounted to RMB11,248 million, representing an increase of 33.7% over the same period last year, and contributed 13.3% of the total revenue, an increase of 3.1 percentage points over the same period in 2005. The ARPU of broadband services reached RMB66.3, precluding a healthy upward trend. The number of IPTV subscribers was 144.5 thousand, representing an increase of 201% over the same period last year.

In 2006, we established China Netcom Group System Integration Limited Corporation, an entity that provides business customers with ICT services that integrate communications, network connectivity and information technology, leveraging off our plentiful fixed-line network resources, rich customer resources and our strong brand identity. It will meet the demand for increasingly diversified and customized needs of our customers, boosting customer retention and loyalty, stabilizing our market share and explore new avenues for revenue growth. Taking advantage of the central government policy to promote an information society, we launched "CNC Connected" services in 2006, promoting ICT services. Tailored to the demands of small- and medium-sized business customers, we developed an integrated solutions platform that allows companies to perform external communications as well as internal information technology related applications. At the same time, we launched a "Broadened Vision" video surveillance product under the auspices of the Government's "Safe City" policy. In 2006, excluding traditional voice and broadband services, revenue from our business customers including ICT services and business & data communications services reached RMB5,267 million.

Our value-added services sustained rapid growth momentum in 2006 as some PHS-based value-added services were successfully applied to the fixed-line telephone. Up to the end of 2006, revenue from our value-added services reached RMB5,421 million, representing an increase of 35.5% over the same period last year, contributing 6.4% of the total revenue. The number of personalized ring subscribers was 15.766 million, of which 8.917 million were fixed line personalized ring subscribers, representing an increase of 480.9% over the same period last year, leading to a penetration rate of 10.2%. PHS SMS volume was 7,815 million messages, representing an increase of 15.3% from last year.

### 4. Olympics-driven Strategic Transformation

Core to our Olympics strategy is to make the 2008 Beijing Olympics a "Digital Olympics" and a "Broadband Olympics" while bringing breakthroughs to high-growth operations and significantly upgrading our organizational management standards.

In the past year, our preparatory work for the Olympic Games moved into an implementation phase. We deployed an Olympics communication service assurance system and signed Olympics broadcasting service co-operation agreements and memorandums of understanding (MoUs) for



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telecommunications co-operation with various carriers, creating the country's largest city-wide intelligent optical network - the Beijing multi-service broadband transmission network. Through these communications infrastructure development for the Olympics, we will ensure the realisation of our "Broadband Olympics" vision, satisfying our customers' needs for stability, safety and flexibility to the maximum extent.

Taking advantage of our ambitious program for the Olympic Games, we will institute the "Broadband Olympics" theme into our new service offerings. Jointly with the Beijing Olympics Committee, we have planned an Olympic-themed fixed communication product system which incorporates the "Broadband Olympics" idea. We seek to leverage off our status as an Olympic partner by launching new products such as "2008 Broadband Hotels". As at the end of 2006, 1,267 hotels had signed up for this service. In April 2006, we reached an agreement with Visa International Service Association on joint marketing rights for Olympic telephone cards. This marked a breakthrough in the Company's commemorative telephone card business.

### 5. Steady Management Innovation and Reasonable Resource Allocation

In 2006 we continued to tighten controls over capital expenditures and resource allocation in an effort to improve our free cash flow and our efficient utilization of capital.

We established an annual revenue assurance plan in accordance with the business plan for 2006. The revenue assurance plan allocated resources reasonably to better

ensure the achievement of our operation targets. With the support of the board of directors and our strategic partners, we increased our management focus on and carefully reviewed and prioritized CAPEX items in order to establish more effective controls.

As a result of improved resource allocation, the Company assigned priority to CAPEX for high-growth services and our strategic transformation. The ratio of CAPEX for high-growth services to total CAPEX rose to 19.8% in 2006 from 15.2% over the same period last year. The ratio of CAPEX for traditional fixed-line services to total CAPEX continued to decline. CAPEX for PHS-related operations also declined by 42.6% to RMB2,748 million.

We will continue to focus on CAPEX controls in 2007 to achieve a higher CAPEX utilization rate. For 2007, the estimated CAPEX is RMB21,000 million, representing a decrease of 20.7% from 2006. We anticipate that the CAPEX to revenue ratio will continue to decrease significantly.

After two years of development work, we achieved decisive success in enterprise resource planning (ERP) and internal control management at the end of 2006. ERP system has been put into place all our service areas. An internal control system based on the Committee of the Sponsoring Organizations of the Treadway Commission (COSO) definitions of internal controls, standards and criteria has been completed and deployed in all areas. The implementation of these two projects will improve the standardization and systemization of our management, raising management standards and bringing about improved efficiency throughout the organization.





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### 6. Business Strategies for 2007

Our business strategies will focus on the following in 2007:

- Traditional fixed-line businesses: continuing to promote bundled services and converged services like "Family 1+" and "Unified Number"; implementing more flexible tariff policies to meet market and customer demands; promoting customer loyalty programs; building integrated, professional customer service systems; establishing a strong and consistent brand image to retain and acquire customers and improve our competitiveness;
- High-growth businesses:
  - Broadband services: On the basis of incessant innovation, continuing the "access + content" fee mechanism and "PC+TV" multi-terminal development model while expanding network capacity to boost access speed; taking advantage of the development of new technologies and the Olympics; introducing an innovative business model to increase the broadband penetration rate; introducing new broadband content and value-added services; promoting the scale development of IPTV; providing intensive marketing of broadband-based bundled services; and increasing brand awareness for our broadband services.
  - Value added services: continuing to promote value-added services such as caller identification display, personalized ring tones, short message service (SMS) and telephone information services; intensifying the bundling of value-added services and basic voice services; and intensifying the promotion of value-added services for fixed network and innovations in the variety of service offerings.
  - Information and Communications Technology (ICT) service: carefully building our ICT business based on the size of different ICT service segments, our compatibility of capacity and the contribution to bundled core telecommunications services including the development of ICT services for SMEs on the current "Small-to Medium-enterprises Information Platform" to provide users with custodian service; providing comprehensive system consultancy and business application system services to large enterprises; providing government agencies with LAN services and outsourcing services; and integrating internal resources, processes, organization structure and review systems to guarantee the rapid development of ICT services.
- Olympics marketing: Under the slogan "Race to 2008", marketing Olympic products such as the expansion of plug-and-play broadband access, "2008 Broadband Hotels", "Broadband City" and marketing Olympic themed products such as Olympic telephone card; and strengthening cooperation with partners on broadband content related to the Olympics;
- Preparing for the delivery of mobile services: expanding our TD-SCDMA trial in Qingdao; and strengthening research into new technologies and services, in order to create a foundation for the convergence of fixed and mobile services and staying ahead of the competition.
- Management improvements: with the recent launch of our ERP system and IT system, improving operational efficiency in terms of finance, network support and marketing. We will leverage off our strategic partnership resources to improve efficiency in terms of budget and CAPEX control, in order to guarantee the mobilization of resources for high-growth services and towards our strategic transformation, thereby increasing our free cash flow.

Based on a philosophy of innovation and development, we are committed to becoming a broadband communications and multi-media services provider in 2007 through our strategic transformation.

I would like to take this opportunity to express our most sincere thanks to our customers, shareholders, board of directors and employees for your trust and support.

**ZUO Xunsheng**  
Chief Executive Officer

Hong Kong, April 2, 2007