

CHINA TELECOM CORP LTD  
Form 20-F  
May 24, 2005  
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## SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

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### FORM 20-F

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**REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR 12(g) OF THE SECURITIES EXCHANGE ACT OF 1934**

OR

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2004

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-31517

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(Exact Name of Registrant as Specified in Its Charter)

# China Telecom Corporation Limited

(Translation of Registrant's Name into English)

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People's Republic of China

(Jurisdiction of Incorporation or Organization)

31 Jinrong Street, Xicheng District

Beijing, China 100032

(Address of Principal Executive Offices)

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Securities registered or to be registered pursuant to Section 12(b) of the Act:

<u>Title of Each Class</u>	<u>Name of Each Exchange On Which Registered</u>
American depositary shares	New York Stock Exchange, Inc.
H shares, par value RMB1.00 per share	New York Stock Exchange, Inc.*

\* Not for trading, but only in connection with the listing on the New York Stock Exchange, Inc. of American depositary shares, each representing 100 H shares.

Securities registered or to be registered pursuant to Section 12(g) of the Act:

None

(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

None

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(Title of Class)

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Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report.

As of December 31, 2004, 67,054,958,321 domestic shares and 13,877,410,000 H shares, par value RMB1.00 per share, were issued and outstanding. H shares are ordinary shares of the Company listed on The Stock Exchange of Hong Kong Limited.

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark which financial statement item the registrant has elected to follow. Item 17  Item 18

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**FORWARD-LOOKING STATEMENTS**

This annual report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements are, by their nature, subject to significant risks and uncertainties, and include, without limitation, statements relating to:

our businesses and operating strategies;

our network expansion and capital expenditure plans;

our operations and business prospects;

the expected benefit of any acquisitions or other strategic transactions;

our financial condition and results of operations;

the future prospects of and our ability to integrate the acquired businesses;

the industry regulatory environment as well as the industry outlook generally; and

future developments in the telecommunications industry in China.

The words anticipate, believe, could, estimate, expect, intend, may, plan, seek, will, would and similar expressions, as they are used in this report, are intended to identify a number of these forward-looking statements.

These forward-looking statements are subject to risks, uncertainties and assumptions, some of which are beyond our control. In addition, these forward-looking statements reflect our current views with respect to future events and are not a guarantee of future performance. We do not intend to update these forward-looking statements. Actual results may differ materially from the information contained in the forward-looking statements as a result of a number of factors, including, without limitation, the risk factors set forth in Item 3. Key Information D. Risk Factors and the following:

any changes in the regulatory policies of the Ministry of Information Industry and other relevant government authorities relating to, among other matters:

- the granting and approval of licenses;

- tariff policies;
- interconnection and settlement arrangements;
- capital investment priorities;
- the provision of telephone services to rural areas in China; and
- numbering resources allocation;

the effects of competition on the demand for and price of our services;

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the development of new technologies and applications or services affecting our current and future businesses;

changes in political, economic, legal and social conditions in China, including the Chinese government's specific policies with respect to foreign investment in and entry by foreign companies into China's telecommunications industry, economic growth, inflation, foreign exchange and the availability of credit; and

changes in population growth and gross domestic product, or GDP, growth and the impact of those changes on the demand for our services.

## **CERTAIN DEFINITIONS AND CONVENTIONS**

As used in this annual report, references to us, we, the Company and China Telecom are to China Telecom Corporation Limited and all of its consolidated subsidiaries except where we make clear that the term means China Telecom Corporation Limited or a particular subsidiary or business group only. References to matters relating to our H shares or ADSs or matters of corporate governance are to the H shares, ADSs and corporate governance of China Telecom Corporation Limited. In respect of any time prior to our incorporation, references to us, we and China Telecom are to the telecommunications businesses in which our predecessors were engaged and which were subsequently assumed by us. All references to China Telecom Group are to China Telecommunications Corporation, our controlling shareholder. Unless the context otherwise requires, these references include all of its subsidiaries, including us and our subsidiaries.

On June 30, 2004, we acquired the entire equity interests in each of Hubei Telecom Company Limited, Hunan Telecom Company Limited, Hainan Telecom Company Limited, Guizhou Telecom Company Limited, Yunnan Telecom Company Limited, Shaanxi Telecom Company Limited, Gansu Telecom Company Limited, Qinghai Telecom Company Limited, Ningxia Telecom Company Limited and Xinjiang Telecom Company Limited from China Telecom Group. As we and these acquired companies were under the common control of China Telecom Group, our acquisition of the acquired companies has been treated as a combination of entities under common control, which was accounted for in a manner similar to a pooling-of-interests. As presented in this annual report, all data and information relating to our businesses and operations include the data and information relating to the businesses and operations of the acquired companies.

## **PART I**

### **Item 1. Identity of Directors, Senior Management and Advisers.**

Not applicable.

### **Item 2. Offer Statistics and Expected Timetable.**

Not applicable.

**Item 3. Key Information.**

**A. Selected Financial Data**

The following table presents our selected financial data. The selected balance sheet data as of December 31, 2003 and 2004, and the selected income statement data and cash flow data for each of the years ended December 31, 2002, 2003 and 2004, are derived from our audited financial statements included elsewhere in this annual report, and should be read in conjunction with our audited financial statements and operating and financial review and prospects included elsewhere in this annual report. The selected balance sheet data as of December 31, 2000, 2001 and 2002

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and the selected income statement and cash flow data for each of the years ended December 31, 2000 and 2001 are derived from our audited financial statements, which are not included in this annual report. Our audited financial statements are prepared and presented in accordance with International Financial Reporting Standards, or IFRS, which differ in certain significant respects from accounting principles generally accepted in the United States of America, or US GAAP. Information relating to the nature and effect of significant differences between IFRS and US GAAP, as they relate to us for the periods described therein, is presented in Note 33 to the audited financial statements included elsewhere in this annual report.

The selected financial data reflect the restructuring in 2001, the acquisitions in 2003 and 2004 described under Item 4. Information on the Company A. History and Development of the Company Our Restructuring and Initial Public Offering , The Acquisition in 2003 and Acquisition in 2004 , respectively, and have been prepared as if our current structure had been in existence throughout the relevant periods. The

Since China Telecom Group controlled the telecommunications operations and the related assets transferred to us prior to our restructuring and continues to control us after our restructuring, the financial data of the telecommunications operations in Shanghai Municipality, Guangdong Province, Jiangsu Province and Zhejiang Province transferred to us by China Telecom Group for periods prior to our incorporation have been combined in a manner similar to a pooling-of-interests. The assets and liabilities of the entities being combined are carried forward at their recorded historical amounts, and the book value of the assets and liabilities, as well as the revenue and expenses of each of these entities for the periods prior to our incorporation, are added together to prepare our financial statements.

On December 31, 2003, we acquired the entire equity interests in each of Anhui Telecom Company Limited, Fujian Telecom Company Limited, Jiangxi Telecom Company Limited, Guangxi Telecom Company Limited, Chongqing Telecom Company Limited and Sichuan Telecom Company Limited from China Telecom Group. On June 30, 2004, we acquired the entire equity interests in each of Hubei Telecom Company Limited, Hunan Telecom Company Limited, Hainan Telecom Company Limited, Guizhou Telecom Company Limited, Yunnan Telecom Company Limited, Shaanxi Telecom Company Limited, Gansu Telecom Company Limited, Qinghai Telecom Company Limited, Ningxia Telecom Company Limited and Xinjiang Telecom Company Limited from China Telecom Group. As we and these acquired companies were under the common control of China Telecom Group, our acquisitions of these acquired companies are accounted for in a manner similar to a pooling-of-interests. Accordingly, the assets and liabilities of the acquired companies have been accounted for at historical amounts and our financial statements for periods prior to the respective acquisitions have been restated to include the financial position and results of operations of the acquired companies on a combined basis. Unless otherwise indicated in this section, our financial data for periods prior to the acquisition in 2004 are presented based on those restated amounts.

In connection with our restructuring in 2001, China Telecom Group retained the ownership of certain assets that were historically associated with our operations and primarily consisted of investments in non-telecommunications industries, inter-provincial optic fibers, international gateway and international transmission equipment, telecommunications equipment for special communications services, and certain office equipment, properties and buildings, and the segregation and separate management of these assets by China Telecom Group took effect on December 31, 2001. In connection with our acquisitions in 2003 and 2004, China Telecom Group retained the ownership of certain assets that were historically associated with our operations and primarily consisted of investments in non-telecommunications industries and certain properties, and the segregation and separate management of these assets by China Telecom Group took effect on December 31, 2002 and December 31, 2003, respectively. With respect to the restructuring in 2001, except for the income statement data for the years ended December 31, 2002, 2003 and 2004, the income statement data for the other periods presented below include the results of the assets retained by China Telecom Group. The results of such assets are not reflected in our income statement for periods beginning after December 31, 2001. These assets are not reflected in our balance sheet as of and after December 31, 2001. With respect to the acquisition in 2003, except for the income statement data for the year ended December 31, 2003 and 2004, the income statement data for the other periods presented below include the results of the assets retained by China Telecom Group. The results of such assets are not reflected in our income statement for periods beginning after December 31, 2002. Except for the balance sheet data as of December 31, 2002, 2003 and 2004, the balance sheet data as of other dates presented below include data related to the assets retained by China Telecom Group in relation to the acquisition in 2003. These assets are not reflected in our balance sheet as of and after December 31, 2002. With respect to the acquisition in 2004, except for the income statement data for the year ended December 31, 2004, the income statement data for the other periods presented below include the results of the assets retained by China Telecom Group. The results of such



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assets are not reflected in our income statement for periods beginning after December 31, 2003. Except for the balance sheet data as of December 31, 2003 and 2004, the balance sheet data as of other dates presented below include data related to the assets retained by China Telecom Group in relation to the acquisition in 2004. These assets are not reflected in our balance sheet as of and after December 31, 2003.

	As of or for the year ended December 31,					
	2000 RMB	2001 RMB	2002 RMB	2003 RMB	2004 RMB	2004 US\$
(in millions, except share numbers and per share and per ADS data)						
<b>Income Statement Data:</b>						
<b>IFRS</b>						
Operating revenue	129,665	130,081	140,906	151,553	161,212	19,478
Operating expenses	(101,085)	(109,367)	(115,798)	(118,701)	(121,382)	(14,665)
Operating income	28,580	20,714	25,108	32,852	39,830	4,813
Income before income tax and minority interests <sup>(2)</sup>	27,432	6,839	6,435	14,407	33,263	4,019
Income tax	(4,556)	1,499	1,856	(469)	(5,187)	(627)
Net income	22,801	8,352	8,219	13,882	28,023	3,386
Basic earnings per share <sup>(1)</sup>	0.33	0.12	0.12	0.18	0.36	0.04
Basic earnings per ADS <sup>(1)</sup>	33.38	12.23	11.87	18.36	35.54	4.29
<b>U.S. GAAP</b>						
Net income	22,801	16,254	16,991	21,452	25,715	3,107
Basic earnings per share <sup>(1)</sup>	0.33	0.24	0.25	0.28	0.33	0.04
Basic earnings per ADS <sup>(1)</sup>	33.38	23.79	24.54	28.37	32.62	3.94
<b>Balance Sheet Data:</b>						
<b>IFRS</b>						
Cash and cash equivalents	25,159	15,274	22,743	12,721	13,465	1,627
Accounts receivable, net	14,324	11,074	11,605	12,951	13,921	1,682
Property, plant and equipment, net <sup>(2)</sup>	285,587	312,326	311,241	309,896	320,179	38,685
Total assets <sup>(2)</sup>	420,199	423,434	423,701	403,942	412,570	49,848
Short-term debt <sup>(3)</sup>	31,376	44,897	53,196	56,243	65,976	7,971
Accounts payable	37,283	38,756	34,859	35,629	33,658	4,067
Long-term obligations	45,924	46,469	39,052	68,675	72,523	8,762
Deferred revenues (excluding current portion)	55,990	49,308	40,894	32,744	25,182	3,043
Total liabilities	253,223	252,974	235,490	251,879	251,951	30,441
Shareholders' equity <sup>(2)</sup>	165,985	169,472	187,025	150,794	159,206	19,236
<b>U.S. GAAP</b>						
Property, plant and equipment, net	285,587	320,102	331,350	339,300	342,718	41,409
Total assets	420,199	431,210	443,810	433,346	435,109	52,572
Shareholders' equity	165,985	174,590	200,406	170,641	176,134	21,281
<b>Cash Flow Data:</b>						
<b>IFRS</b>						
Cash flows from operating activities	59,341	57,083	62,357	58,392	66,078	7,984
Net cash used in investing activities <sup>(4)</sup>	(71,030)	(75,073)	(62,578)	(57,094)	(56,353)	(6,809)
Capital expenditures <sup>(4)</sup>	(68,901)	(73,976)	(61,437)	(57,692)	(56,446)	(6,820)
Net cash from / (used in) financing activities	7,634	8,105	7,690	(11,320)	(8,981)	(1,085)

- (1) The basic earnings per share have been calculated based on the net income of RMB22,801 million, RMB8,352 million, RMB8,219 million, RMB13,882 million and RMB28,023 million, respectively, for the years ended December 31, 2000, 2001, 2002, 2003 and 2004, and the weighted average number of shares in issue during the relevant year of 68,317,270,803, 68,317,270,803, 69,241,674,942, 75,614,186,503 and 78,839,968,917 shares, respectively, as if the 68,317,270,803 shares issued and outstanding upon our formation on September 10, 2002 had been outstanding for all periods presented. Basic earnings per ADS have been computed as if all of our issued and outstanding shares, including domestic shares and H shares, are represented by ADSs during each of the years presented. Each ADS represents 100 H shares.



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- (2) Includes the effect of the revaluation of property, plant and equipment as of December 31, 2001 in connection with our restructuring and as of December 31, 2002 and as of December 31, 2003 in connection with our acquisitions. It also includes the effect of the Company's revaluation of property, plant and equipment as of December 31, 2004 which was carried out in accordance with the Company's accounting policies under IFRS. See Note 7 to our audited financial statements.
- (3) Excludes current portion of long-term debt.
- (4) Capital expenditures are part of and not an addition to net cash used in investing activities.

Pursuant to the shareholders' approval at the annual general meeting held on May 3, 2004, a final dividend of RMB0.069083 equivalent to HK\$0.065 per share totaling RMB5,224 million in respect of the year ended December 31, 2003 was declared and was paid on May 20, 2004. Holders of our ADRs received a dividend of USD\$0.8333 per share in 2004 based on the exchange rate of HK\$7.80=US\$1.00.

Pursuant to a resolution passed at the directors' meeting on March 31, 2005, a final dividend of equivalent to HK\$0.065 per share totaling approximately RMB5,576 million for the year ended December 31, 2004 was proposed for shareholders' approval at the annual general meeting. The dividend has not been provided for in the consolidated financial statements for the year ended December 31, 2004.

**Exchange Rate Information**

Our financial statements are expressed in Renminbi. Solely for the convenience of the reader, this annual report contains translations of certain Renminbi and Hong Kong dollar amounts into U.S. dollars and vice versa at RMB8.2765 = US\$1.00 and HK\$7.7723 = US\$1.00, the noon buying rates in New York City for cable transfers as certified for customs purposes by the Federal Reserve Bank of New York on December 31, 2004. These translations should not be construed as representations that the Renminbi or Hong Kong dollar amounts could have been or could be converted into U.S. dollars at such rates or at all.

The noon buying rates in New York City for cable transfers as certified for customs purposes by the Federal Reserve Bank of New York were RMB8.2765 = US\$1.00 and HK\$7.7861 = US\$1.00, respectively, on May 23, 2005. The following table sets forth the high and low noon buying rates between Renminbi and U.S. dollars and between Hong Kong dollars and U.S. dollars for each month during the previous six months:

**Noon Buying Rate**

	RMB per US\$1.00			HK\$ per US\$1.00	
	High	Low		High	Low
November 2004	8.2765	8.2764	November 2004	7.7815	7.7718
December 2004	8.2767	8.2765	December 2004	7.7821	7.7698
January 2005	8.2765	8.2765	January 2005	7.7994	7.7775
February 2005	8.2765	8.2765	February 2005	7.7999	7.7984
March 2005	8.2765	8.2765	March 2005	7.7998	7.7987
April 2005	8.2765	8.2765	April 2005	7.7995	7.7946
May 2005 (as of May 23)	8.2765	8.2765	May 2005 (as of May 23)	7.7995	7.7861

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The following table sets forth the average noon buying rates between Renminbi and U.S. dollars and between Hong Kong dollars and U.S. dollars for each of 2000, 2001, 2002, 2003 and 2004, calculated by averaging the noon buying rates on the last day of each month during each of the relevant years.

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	<u>RMB per US\$1.00</u>	<u>HK\$ per US\$1.00</u>
2000	8.2784	7.7936
2001	8.2772	7.7997
2002	8.2772	7.7996
2003	8.2771	7.7864
2004	8.2768	7.7899

**B. Capitalization and Indebtedness**

Not applicable.

**C. Reasons for the Offer and Use of Proceeds**

Not applicable.

**D. Risk Factors*****Risks Relating to Our Businesses***

*We face increasing competition, which may adversely affect our business growth and results of operations.*

The telecommunications industry in China is rapidly evolving. Until the mid-1990s, we were the sole provider of wireline telecommunications services in our service regions and, as a result, we had a dominant market position in our service regions. We began to operate in a competitive market as the Chinese government started to implement a number of measures to restructure the telecommunications industry and encourage competition in the industry in the mid-1990s. We face increasing competition from other telecommunications service providers in China. We expect our competitors to expand further their network coverage and increase their sales and marketing efforts in our service regions. See Item 4. Information on the Company B. Business Overview Competition. In particular:

we face indirect competition in our local wireline telephone services from China's two mobile telephone service providers, China Mobile Communications Corporation, or China Mobile, and China United Telecommunications Corporation, or China Unicom, and have begun to face direct competition from China Railway Communication Co., Ltd., or China Railcom, and China Network Communications Group Corporation, or China Netcom Group;

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we face increasingly intense competition in our long distance telephone services from other providers of long distance services using public switched telephone networks, including China Unicom, China Railcom and China Netcom Group, and other providers of long distance services using the voice-over-Internet-protocol, or VoIP, technology, including China Mobile, China Unicom, China Netcom Group and China Railcom;

we face increasing competition in our Internet and managed data services from many competitors, including, primarily, China Unicom, China Netcom Group, China Mobile and China Railcom; and

we may face additional competition from new entrants or providers of new telecommunications services, such as telephone and Internet services offered over cable TV networks.

Moreover, as a result of China's accession to the World Trade Organization, or the WTO, and the adoption of the Regulations on the Administration of Foreign-Invested Telecommunications Enterprises in January 2002, which implement China's commitments to the WTO, the Chinese government has agreed to gradually liberalize the various segments and regions of the telecommunications market in China to foreign operators. See Item 4. Information on the Company B. Business Overview Regulatory and Related Matters Licensing. Both the percentage of ownership of Sino-foreign joint ventures offering telecommunications services in China and the regions where those



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joint ventures are permitted to offer telecommunications services might be increased over the next several years. These and other potential new entrants into the Chinese telecommunications market may further increase the competitive pressure we face.

Our ability to compete effectively may be constrained by a number of factors. For example, under the Chinese government's policy of promoting competition in the telecommunications industry, certain competitors of ours, such as China Unicom and China Railcom, continue to enjoy certain preferential treatment from the Chinese government in tariff setting. They may set their respective tariffs for long distance services using public switched telephone networks and leased line services at levels below the tariffs of our company with the annual approval of the regulatory authorities. This preferential treatment is not available to us. As a result, our competitors who enjoy this preferential treatment may be able to provide their services at prices that are more competitive than ours.

In addition, we are not yet permitted to provide mobile communications services. We, through China Telecom Group, are, however, actively seeking the issuance of a license for mobile communications services in the PRC. We can provide no assurances, however, as to whether or when we may be able to receive any benefit of any license for mobile communications in China. Moreover, if we receive the necessary license and commence providing mobile communications services, we will compete with other telecommunications providers not only in our traditional wireline services, but also in mobile telecommunications services.

As a result, our customers may choose to use other providers' services. Increased competition from those providers may force us to lower our tariffs to the extent permitted under relevant laws and regulations, may reduce or reverse the growth of our customer base and may reduce usage of our networks. Any of these developments could materially adversely affect our business growth and results of operations.

***We will continue to be controlled by China Telecom Group, which could cause us to take actions that may conflict with the best interests of our other shareholders.***

China Telecom Group, a wholly state-owned enterprise, currently owns approximately 72.09% of our outstanding shares. Accordingly, subject to our articles of association and applicable laws and regulations, China Telecom Group, as our controlling shareholder, will continue to be able to exercise significant influence over our management and policies by:

controlling the election of our directors and, in turn, indirectly controlling the selection of our senior management;

determining the timing and amount of our dividend payments;

approving our annual budgets;

deciding on increases or decreases in our share capital;

determining issuance of new securities;

approving mergers and acquisitions; and

amending our articles of association.

The interests of China Telecom Group as our controlling shareholder could conflict with our interests or the interests of our other shareholders. As a result, China Telecom Group may take actions with respect to our businesses that may not be in our or our other shareholders' best interests.

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*The letter of undertakings provided to us by China Telecom Group contains vague terms that may not be implemented as we expect.*

China Telecom Group has provided us a letter of undertakings, under which it has undertaken to support us in our existing operations and future development in the following specific areas:

to treat us equally with any other operators of wireline telephone, Internet and managed data, leased line and other related telecommunications services that are controlled by China Telecom Group;

to give us the right to provide additional telecommunications services in our service regions that fall within the business scope of China Telecom Group; and

to give us the preferential right to acquire China Telecom Group's interest in companies or other entities that provide telecommunications services.

The current terms of the letter of undertakings do not obligate China Telecom Group to provide any financial support to us. The letter of undertakings may not be implemented as we expect due to the vagueness of its terms. Other than the letter of undertakings, we have not entered into any agreement with China Telecom Group to provide for potential allocation of business opportunities between China Telecom Group and us outside our service regions.

*We face uncertainties associated with the process to implement our strategy to transform from a traditional wireline network operator into a modern integrated information services provider.*

Our business strategy will focus on transforming from a traditional wireline network operator into a modern integrated information services provider. As part of the strategy, we plan to continue pursuing the operation of mobile business proactively and seek to work with IT service providers to offer differentiated total solutions to enterprise customers. We will exploit the development potential of rural telephony, value-added services, leased line and other services.

However, we cannot assure you that the implementation of this new business strategy will not be delayed, or that the strategy will ever be successfully implemented. We cannot assure you that we will be able to obtain the necessary consents, licenses and approvals from national and local governments to conduct new services. We cannot assure you that we can develop sufficient technology to support our new businesses. Even if our initiatives of transformation can be implemented, we cannot assure you that these initiatives will allow us to increase revenues from our existing service offerings or from new communications services. The success of new service development depends on many factors, including, but not limited to, receipt of necessary government approval, proper identification of customer needs, successful development of technology, the ability to manage cost and expenses, timely completion and introduction of new services, differentiation from offerings of competitors and market acceptance. The uncertainties associated with these factors could materially adversely affect our future business and operation.

*We depend on China Telecom Group and its other subsidiaries to provide certain services and facilities for which we currently have limited alternative sources of supply.*

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In addition to being our controlling shareholder, China Telecom Group, by itself and through its other subsidiaries, also provides us with services and facilities necessary for our business activities, including, but not limited to:

use of international gateway facilities;

provision of services in areas outside our service regions necessary to enable us to provide end-to-end services to our customers;

use of nationwide inter-provincial optic fibers; and

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lease of properties.

The interests of China Telecom Group and its other subsidiaries as providers of these services and facilities may conflict with our interests. We currently have limited alternative sources of supply for these services. Therefore, we have limited leverage in negotiating with China Telecom Group and its other subsidiaries over the terms for the provision of these services. See Item 7. Major Shareholders and Related Party Transactions B. Related Party Transactions for a detailed description of the services provided by China Telecom Group and its other subsidiaries.

***Since our services require interconnection with networks of other operators, disruption in interconnections with those networks could have a material adverse effect on our business and results of operations.***

Under the relevant telecommunications regulations, telecommunications operators are required to interconnect with networks of other operators. We have entered into interconnection arrangements with other telecommunications operators. Any disruption of our interconnection with the networks of those operators could have a material adverse effect on our business and results of operations. In particular, as a result of the restructuring of China's wireline telecommunications sector, most wireline telecommunications assets except for the nationwide inter-provincial optic fibers, including the last-mile access network, formerly owned by China Telecom Group in ten northern provinces in China were allocated to China Netcom Group. As we and China Telecom Group have limited local access facilities in those ten provinces, we will need to interconnect, indirectly through China Telecom Group, with China Netcom Group in order to provide end-to-end services to our customers with operations in the ten northern provinces. Any interruption in our interconnection with China Netcom Group could have a material adverse effect on our business and results of operations.

***We may be unable to obtain sufficient financing to fund our capital requirements, which could limit our growth potential and future prospects.***

We believe that cash from operations, together with any necessary borrowings, will provide sufficient financial resources to meet our projected capital and other expenditure requirements. We may require additional funds to the extent we have underestimated our capital requirements or overestimated our future cash from operations. In addition, a significant feature of our business strategy is to explore opportunities to transform from a traditional network operator into a modern integrated information services provider, which may require additional capital resources. The cost of implementing new technologies, upgrading our networks or expanding capacity may also be significant. In particular, in order for us to effectively respond to technological changes and more intensive competition, we may be required to make substantial capital expenditures in the future.

Financing may not be available to us on acceptable terms or at all. In addition, any future issuance of equity securities, including securities convertible or exchangeable into or that represent the right to receive equity securities, may require approval from the relevant government authorities. Our ability to obtain additional financing will depend on a number of factors, including:

our future financial condition, results of operations and cash flows;

general market conditions for financing activities by telecommunications companies; and

economic, political and other conditions in the markets where we operate.

We cannot assure you that we can obtain sufficient financing at commercially reasonable terms or at all. If adequate capital is not available, our growth potential and future prospects could be adversely affected.

*If we are not able to respond successfully to technological or industry developments, our business may be adversely affected.*

The telecommunications market is characterized by rapid advancements in technology, evolving industry standards and changes in customer needs. We cannot assure you that we will be successful in responding to these

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developments. In addition, new services or technologies may render our existing services or technologies less competitive. In the event we do take measures to respond to technological developments and industry standard changes, the integration of new technology or industry standards or the upgrading of our networks may require substantial time, effort and capital investment. We cannot assure you that we will succeed in integrating these new technologies and industry standards or adapting our network system in a timely and cost-effective manner, or at all. Our inability to respond successfully to technological or industry developments may adversely affect our businesses, results of operations and competitiveness.

*We face a number of risks relating to our Internet-related businesses.*

We currently provide a range of Internet-related services, including dial-up and broadband Internet access and Internet-related applications. We face a number of risks in providing these services.

Our network may be vulnerable to unauthorized access, computer viruses and other disruptive problems. We cannot assure you that the security measures we have implemented will not be circumvented or otherwise fail to protect the integrity of our network. Unauthorized access could jeopardize the security of confidential information stored in our customers' computer systems. Eliminating computer viruses and other security problems may also require interruptions, delays or suspension of our services, cause us to incur costs and divert management attention.

In addition, because we provide connections to the Internet and host websites for customers and develop Internet content and applications, we may be perceived as being associated with the content carried over our network or displayed on websites that we host. We cannot and do not screen all of this content and may face litigation claims due to a perceived association with this content. These types of claims have been brought against other providers of online services in the past and can be costly to defend regardless of the merits of the lawsuit and may damage our reputation.

*Our Personal Handyphone System business may lose its competitiveness due to price fluctuation of mobile services and difficulties on further development of its technologies.*

We currently provide Personal Handyphone System, or PHS, services in our service regions. PHS is a telecommunications technology that allows us to offer to our customers wireless local access services with mobility within an area with the same area code. Our ability to realize acceptable returns from our investment in PHS technology will depend on continued customer adoption of this technology. However, this market may not continue to develop. If China Mobile or China Unicom reduces the tariffs for mobile telecommunications services, our existing and potential PHS customers may choose to use these services instead of our PHS services to take advantage of the less geographically restricted service scope and other features of mobile technology, or we may have to reduce our PHS tariff. Our PHS is also facing difficulties in improving its technology. If we cannot improve technologies to support PHS' future development and customers' needs, our PHS business will be adversely affected.

*If the new applications adopted by us do not perform as expected, or if we are unable to deliver commercially viable services based on these applications, our revenue and profitability may not grow as we expect.*

We are pursuing a number of new growth opportunities in the broader telecommunications industry, including advanced data and broadband information and application services. These opportunities relate to new services for which there are no established markets in China. Our ability

to deploy and deliver these new services depends, in many instances, on the development of new applications, which may not be developed successfully or may not perform as we expect.

In addition, the success of our broadband Internet services is substantially dependent on the availability of content, applications and devices provided by third-party developers. If we are unable to deliver commercially viable new services, our revenue and profitability will not grow as we expect and our competitiveness may be adversely affected.



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*Risks Relating to the Telecommunications Industry in China*

*Extensive government regulation of the telecommunications industry may limit our flexibility in responding to market conditions, competition or changes in our cost structure.*

Our businesses are subject to extensive government regulation. The Ministry of Information Industry, which is the primary telecommunications industry regulator under China's State Council, regulates, among other things:

industry policies and regulations;

licensing;

tariffs;

competition;

telecommunications resource allocation;

service standards;

technical standards;

interconnection and settlement arrangements;

enforcement of industry regulations; and

universal service obligations.

Other Chinese governmental authorities also take part in regulating tariff policies, capital investment and foreign investment in the telecommunications industry. Major capital investments, including telecommunications network development projects, are subject to the approval of relevant Chinese government authorities. See Item 4. Information on the Company B. Business Overview Regulatory and Related Matters Capital Investment. The regulatory framework within which we operate may constrain our ability to implement our business strategies and limit our flexibility to respond to market conditions or to changes in our cost structure.

*Possible future industry restructurings may adversely affect our businesses.*

The PRC telecommunications industry has undergone restructuring from time to time in the past and may be subject to further restructuring. Possible future restructuring might change the competition environment in the PRC telecommunications industry. The fast development of new technologies might also cause the PRC government to make other adjustments of the existing structure of the industry. Such further industry restructuring may affect the operations of all telecommunications operators in China, including us. Accordingly, we cannot predict the implications and effect of any further restructuring on our operations.

*Our revenues may be adversely affected by reductions in tariffs mandated by the Chinese government.*

Tariffs are the prices we charge our customers for our telecommunications services. We are subject to extensive government regulations on tariffs, especially those relating to our basic telecommunications services. Currently, the relevant provincial communications administrations and provincial price bureaus determine the monthly fee and usage fee tariffs for our wireline local telephone services, based on a guidance tariff range set by the Ministry of Information Industry in consultation with the National Development and Reform Commission. The Ministry of Information Industry and the National Development and Reform Commission jointly set tariffs for all domestic and international, Hong Kong, Macau and Taiwan long distance services using public switched telephone networks,

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leased lines and managed data services. See Item 4. Information on the Company B. Business Overview Regulatory and Related Matters Tariff Setting. We derive a substantial portion of our revenues from services that are subject to tariffs determined by the Chinese government. In the past, our revenues have been adversely affected by reductions in tariffs mandated by the Chinese government. In September 2002, the Ministry of Information Industry indicated in writing that it does not intend to initiate any adjustment to tariffs for wireline local telephone services during the next three to five years. We believe therefore that the risk of adjustment of such tariffs in such period has been substantially reduced. However, we cannot predict with accuracy or assure you on the timing, likelihood or likely magnitude of tariff adjustments generally or the extent or potential impact on our businesses of future tariff adjustments. We cannot assure you that our businesses or results of operations will not be adversely affected by any government-mandated tariff adjustments in the future.

*Future changes to the regulations and policies governing the telecommunications industry in China may have a material adverse effect on our businesses and operations.*

The regulations and policies governing the telecommunications industry in China experienced continuous changes in the past several years. Possible future changes to regulations and policies of the Chinese government governing the telecommunications industry could adversely affect our businesses and operations. For example, to provide a uniform regulatory framework for the orderly development of the telecommunications industry, the Chinese government is currently preparing a draft telecommunications law. If and when the telecommunications law is adopted by the National Peoples Congress or its Standing Committee, it is expected to provide a new regulatory framework for telecommunications regulation in China. We cannot be certain how this law will affect our businesses and operations and whether it will contain provisions more stringent than the current telecommunications regulations.

The interpretation and enforcement of China's WTO commitments regarding telecommunications services may also affect telecommunications regulations and the telecommunications industry in China. Any future regulatory changes, such as those relating to the issuance of additional telecommunications licenses, tariff setting, interconnection and settlement arrangements, competition, changes in technical and service standards, universal service obligations and spectrum and numbering resources allocations, may have a material adverse effect on our business and operations.

*The Chinese government may require us, along with other providers in China, to provide universal services with specified obligations, and we may not be compensated adequately for providing such services.*

Under the Telecommunications Regulations promulgated by the State Council, telecommunications service providers in China are required to fulfill universal service obligations in accordance with relevant regulations to be promulgated by the Chinese government, and the Ministry of Information Industry has the authority to delineate the scope of universal service obligations. The Ministry of Information Industry may also select universal service providers through a tendering process. The Ministry of Information Industry, together with government finance and pricing authorities, is also responsible for formulating administrative rules relating to the establishment of a universal service fund and compensation schemes for universal services.

Consequently, we may not be able to realize adequate return on investments for expanding networks to, and providing telecommunications services in, those economically less developed areas due to potentially higher capital expenditure requirements, lower usage by customers and lack of flexibility in setting our tariffs. As a result, our financial condition and results of operations could be adversely affected.

*Risks Relating to the People's Republic of China*

Substantially all of our assets are located in China and substantially all of our revenue is derived from our operations in China. Accordingly, our results of operations and prospects are subject, to a significant extent, to the economic, political and legal developments in China.

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*China's economic, political and social conditions, as well as government policies, could affect our businesses.*

Substantially all of our businesses, assets and operations are located in China. The economy of China differs from the economies of most developed countries in many respects, including without limitation:

government involvement;

level of development;

growth rate;

control of foreign exchange; and

allocation of resources.

While China's economy has experienced significant growth in the past twenty years, growth has been uneven, both geographically and among various sectors of the economy. The Chinese government has implemented various measures to encourage economic growth and guide the allocation of resources. Some of these measures benefit the overall economy of China, but may also have a negative effect on us. For example, our operating results and financial condition may be adversely affected by government control over capital investments or changes in tax regulations applicable to us.

The economy of China has been transitioning from a planned economy to a more market-oriented economy. Although in recent years the Chinese government has implemented measures emphasizing the utilization of market forces for economic reform, the reduction of state ownership of productive assets and the establishment of sound corporate governance in business enterprises, a substantial portion of productive assets in China is still owned by the Chinese government. In addition, the Chinese government continues to play a significant role in regulating industry development by imposing industrial policies. It also exercises significant control over China's economic growth through the allocation of resources, controlling payment of foreign currency-denominated obligations, setting monetary policy and providing preferential treatment to particular industries or companies. We cannot predict the purpose and effect of future economic policies of the PRC government or the impact of such economic policies on our businesses and operations.

*Government control of currency conversion may adversely affect our financial condition.*

We receive substantially all of our revenues in Renminbi, which currently is not a freely convertible currency. A portion of these revenues must be converted into other currencies to meet our foreign currency obligations. These foreign currency-denominated obligations include:

payment of interest and principal on foreign currency-denominated debt;

payment for equipment and materials purchased offshore; and

payment of dividends declared, if any, in respect of our H shares.

Under China's existing foreign exchange regulations, we will be able to pay dividends in foreign currencies without prior approval from the State Administration of Foreign Exchange by complying with certain procedural requirements. However, the Chinese government may take measures at its discretion in the future to restrict access to foreign currencies for both current account transactions and capital account transactions if foreign currencies become scarce in China. We may not be able to pay dividends in foreign currencies to our shareholders, including holders of our ADRs, if the Chinese government restricts access to foreign currencies for current account transactions.

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Foreign exchange transactions under our capital account, including foreign currency-denominated borrowings from foreign banks, issuance of foreign currency-denominated debt securities, if any, and principal payments in respect of foreign currency-denominated obligations, continue to be subject to significant foreign exchange controls and require the approval of the State Administration of Foreign Exchange. These limitations could affect our ability to obtain foreign exchange through debt or equity financing, or to obtain foreign exchange to meet our payment obligations under the debt securities, if any, or to obtain foreign exchange for capital expenditures.

### ***Fluctuation of the Renminbi could materially affect our financial condition and results of operations.***

We receive substantially all of our revenues, and our financial statements are presented, in Renminbi. The value of the Renminbi fluctuates and is subject to changes in China's political and economic conditions. Since 1994, the conversion of Renminbi into foreign currencies, including Hong Kong dollars and U.S. dollars, has been based on rates set by the People's Bank of China. Fluctuations in exchange rates may adversely affect the value, translated or converted into U.S. dollars or Hong Kong dollars, of our net assets, earnings and any declared dividends payable on our H shares in foreign currency terms. Our financial condition and results of operations may also be affected by changes in the value of certain currencies other than the Renminbi, in which our obligations are denominated. For further information on our foreign exchange risks and certain exchange rates, see Item 3. Key Information A. Selected Financial Data Exchange Rate Information and Item 11. Quantitative and Qualitative Disclosure about Market Risk Foreign Exchange Rate Risk. We cannot assure you that any future movements in the exchange rate of the Renminbi against the U.S. dollar or other foreign currencies will not adversely affect our results of operations and financial condition.

### ***The PRC legal system has inherent uncertainties that could limit the legal protections available to you.***

We were incorporated under the laws of the PRC and are governed by our articles of association. The Chinese legal system is based on written statutes. Prior court decisions may be cited for reference but have limited precedential value. Since 1979, the Chinese government has promulgated laws and regulations dealing with economic matters such as foreign investment, corporate organization and governance, commerce, taxation and trade. However, because these laws and regulations are relatively new, and because of the limited volumes of published cases and their non-binding nature, interpretation and enforcement of these laws and regulations involve uncertainties.

The direct enforcement by our shareholders of their rights in respect of violations of corporate governance procedures may be limited. In this regard, our articles of association provide that most disputes between holders of H shares and our company, directors, supervisors, officers or holders of domestic shares, arising out of our articles of association or the PRC Company Law and related regulations concerning the affairs of our company, are to be resolved through arbitration by arbitration tribunal in Hong Kong or China, rather than by a court of law. Awards that are made by Chinese arbitral authorities recognized under the Arbitration Ordinance of Hong Kong can be enforced in Hong Kong. Hong Kong arbitration awards are also enforceable in China. However, to our knowledge, no action has been brought in China by any holder of H shares to enforce an arbitral award, and we are uncertain as to the outcome of any action, if brought in China to enforce an arbitral award made in favor of holders of H shares. See Item 10. Additional Information B. Articles of Association.

To our knowledge, there has not been any published report of judicial enforcement in China by holders of H shares of their rights under the articles of association or the PRC Company Law.

Unlike in the United States, under applicable laws of China, shareholders do not have the right to sue the directors, supervisors, officers or other shareholders on behalf of the corporation to enforce a claim against such party or parties that the corporation has failed to enforce itself. Our shareholders may have to rely on other means to enforce directly their rights, such as through administrative proceedings. Chinese laws and regulations applicable to overseas listed companies do not distinguish among minority, affiliated and unaffiliated shareholders in terms of their

rights and protections. In addition, our minority shareholders may not be able to enjoy protections to the same extent afforded to them by companies incorporated under the laws of the United States.



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Although we will be subject to the Hong Kong Stock Exchange Listing Rules, or the Listing Rules, and the Hong Kong Codes on Takeovers and Mergers and Share Repurchases, or the Codes, the holders of H shares will not be able to bring actions on the basis of violations of the Listing Rules or the Codes, and must rely on the Hong Kong Stock Exchange and The Securities and Futures Commission of Hong Kong to enforce the Listing Rules or the Codes, as the case may be.

*You may experience difficulties in effecting service of legal process and enforcing judgments against us and our management.*

We are a company incorporated under the laws of the PRC, and substantially all of our assets and our subsidiaries are located in China. In addition, most of our directors and officers reside within China, and substantially all of the assets of our directors and officers are located within China. As a result, it may not be possible to effect service of process within the United States or elsewhere outside China upon most of our directors or officers, including with respect to matters arising under applicable laws and regulations. Moreover, our Chinese counsel has advised us that China does not have treaties providing for the reciprocal recognition and enforcement of judgments of courts with the United States, the United Kingdom, Japan or most other Western countries. Our Hong Kong counsel has also advised us that Hong Kong has no arrangement for the reciprocal enforcement of judgments with the United States. As a result, recognition and enforcement in China of judgments of a court in the United States and any of the other jurisdictions mentioned above in relation to any matter not subject to a binding arbitration provision may be difficult or impossible.

*Holders of H shares may be subject to PRC taxation.*

Under China's current tax laws, regulations and rulings, dividends paid by us to holders of our H shares outside the PRC are currently exempted from PRC income tax. In addition, gains realized by individuals or enterprises upon the sale or other disposition of our H shares are currently exempted from PRC capital gains tax. If the exemptions are withdrawn in the future, holders of our H shares may be required to pay withholding tax on dividends, which is currently imposed at the rate of 20%, or income tax, which may be imposed upon individuals at the rate of 20%, and holders of our H shares may be required to pay PRC capital gains tax upon the sale or other disposition of our H shares. See Item 10. Additional Information E. Taxation People's Republic of China.

## **Item 4. Information on the Company.**

### **A. History and Development of the Company**

#### **Restructuring of the Telecommunications Industry**

Historically, the former Ministry of Posts and Telecommunications, through the former Directorate General of Telecommunications, provincial Posts and Telecommunications Administrations and their city- and county-level posts and telecommunications bureaus, controlled and operated public telecommunications networks and businesses in China.

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As part of the Chinese government's restructuring of the telecommunications industry, the Ministry of Information Industry was formed in March 1998 to assume, among other matters, the regulatory responsibilities of the former Ministry of Posts and Telecommunications.

In 1999, with the approval of the State Council, the telecommunications networks and businesses previously controlled and operated by the former Ministry of Posts and Telecommunications were separated along four business lines: wireline, mobile, paging and satellite communications. The Directorate General of Telecommunications was renamed China Telecommunications Corporation in May 2000 to operate the nationwide wireline telecommunications business resulting from such separation. China Mobile and China Satellite Communications Corporation, or China Satellite, were established in May 2000 and December 2001, respectively, as state-owned enterprises to assume the nationwide mobile business and satellite communications business, respectively, while the paging business was transferred to China Unicom.

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### **Restructuring of China Telecom Group**

In November 2001, the telecommunications assets of our parent company, China Telecom Group, in ten northern provinces, autonomous regions and centrally administered municipalities in China were split off from China Telecom Group in May 2002 and were merged with China Netcom Corporation and Jitong Communications Co. Ltd. to form China Netcom Group. China Telecom Group retains the telecommunications assets in the remaining 21 provinces, autonomous regions and centrally administered municipalities and continues to own the brand name of China Telecom. Under the restructuring plan, both China Telecom Group and China Netcom Group are permitted to operate nationwide wireline telecommunications networks and provide nationwide services.

In connection with the implementation of the restructuring plan, China Telecom Group and China Netcom Group entered into a number of framework agreements providing for the division of network resources, trademarks, network access codes and other assets and nationwide enterprise customers of China Telecom Group prior to the restructuring, and circuit leasing, network maintenance and other business arrangements. Under these framework agreements, we obtained, indirectly through China Telecom Group, access to local networks owned by China Netcom Group in the ten northern provinces, autonomous regions and centrally administered municipalities. China Telecom Group and China Netcom Group also entered into a couple of implementation agreements in 2002, 2003 and 2004 to implement those framework agreements, the provisions of which are consistent with those framework agreements.

### **Our Restructuring and Initial Public Offering**

We were incorporated under the laws of China on September 10, 2002 as a joint stock company with limited liability under the name of China Telecom Corporation Limited. Our controlling shareholder, China Telecom Group, a wholly state-owned enterprise, directly owns approximately 72.09% of our issued capital as of May 23, 2005. As part of the restructuring, China Telecom Group's telecommunications operations in Shanghai Municipality, Guangdong Province, Jiangsu Province and Zhejiang Province, together with the related assets and liabilities, were transferred to us. These assets, liabilities and operations have been segregated and separately managed by us since December 31, 2001. As part of the restructuring, China Telecom Group retained certain assets historically associated with the businesses in Shanghai Municipality, Guangdong Province, Jiangsu Province and Zhejiang Province. These assets had a carrying amount of RMB11,285 million as of December 31, 2001 and primarily consisted of investments in non-telecommunications industries, the inter-provincial transmission optic fibers and properties. In consideration of the net assets related to the telecommunications operations transferred to us, which had a carrying amount of RMB97,485 million as of December 31, 2001, we issued 68,317,270,803 of our shares to China Telecom Group.

The telecommunications operations that were transferred to us included:

wireline telephone services, including local telephone, domestic and international, Hong Kong, Macau and Taiwan long distance and interconnection services as well as a range of related value-added services;

Internet and managed data services, including dial-up Internet access, broadband Internet access, managed data, system integration and related value-added services; and

leased line services.

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Under the restructuring agreement, China Telecom Group has undertaken to indemnify us against any actions, suits, proceedings, claims, losses, damages, payments or other expenses caused by or arising from any assets transferred to us by China Telecom Group due to events that occurred prior to the effective date of our restructuring.

In addition, under the restructuring agreement, China Telecom Group has undertaken to indemnify us against any liabilities or losses as a result of any adverse effect that agreements entered or to be entered into between China Telecom Group and China Netcom Group may have on our assets and operations or the implementation of our agreements with China Telecom Group.

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Immediately prior to our initial public offering, China Telecom Group owned 87.01% of our outstanding shares. In addition, Guangdong Rising Assets Management Co., Ltd., Jiangsu Guoxin Investment Group Co., Ltd. and Zhejiang Financial Development Company each owned 8.37%, 1.43% and 3.19%, respectively, of our outstanding shares. As part of a reform plan approved by the State Council on the administration of rural telecommunications services in 2002, China Telecom Group transferred a portion of its interest in our company to these shareholders, which are state-owned enterprises owned and controlled by the provincial governments in each of Guangdong Province, Jiangsu Province and Zhejiang Province, as compensation for the financial support they have provided historically in the construction of rural telecommunications infrastructure in their provinces. See Item 7. Major Shareholders and Related Party Transactions B. Related Party Transactions. Under a share transfer agreement each of these shareholders has entered into with China Telecom Group, each of Guangdong Rising Assets Management Co., Ltd., Jiangsu Guoxin Investment Group Co., Ltd. and Zhejiang Financial Development Company has agreed, unless otherwise agreed by China Telecom Group:

not to sell, transfer or pledge any of our shares it obtained under the share transfer agreement during the three-year period after November 15, 2002, and

following the expiry of the three-year period after November 15, 2002, not to sell or transfer more than 20% of our shares it obtained under the share transfer agreement during any six-month period for two years.

China Telecom Group has undertaken to give us a preferential right to acquire its interest in companies or other entities that provide telecommunications services. See Item 7. Major Shareholders and Related Party Transactions B. Related Party Transactions Arrangements Relating to Our Restructuring and Initial Public Offering Letter of Undertakings.

Under a non-competition agreement between us and China Telecom Group, China Telecom Group has undertaken to us, for so long as our shares are listed on the Hong Kong Stock Exchange or another exchange, and China Telecom Group holds over 30% of our issued share capital or is regarded as our controlling shareholder under the Listing Rules, China Telecom Group will not at any time, directly or indirectly, provide basic telecommunications services or selected value-added telecommunications services in our service regions that may compete with us. See Item 7. Major Shareholders and Related Party Transactions B. Related Party Transactions Arrangements Relating to Our Restructuring and Initial Public Offering Non-Competition Agreement.

In connection with our restructuring and acquisitions, we entered into various arrangements with China Telecom Group and a number of its provincial subsidiaries relating to the mutual provision of ongoing telecommunications and other services. These agreements include agreements for trademark licensing, centralized services, interconnection arrangements, optic fiber leasing, property leasing, IT services, comprehensive services and other services. See Item 7. Major Shareholders and Related Party Transactions B. Related Party Transactions for a more detailed description of these arrangements.

Following our restructuring, China Telecom Group continues to be the holder of the licenses required for operating our telecommunications business. In accordance with the approval of the Ministry of Information Industry, we derive our exclusive rights to operate our businesses from our status as a subsidiary controlled by China Telecom Group, and China Telecom Group must hold and maintain all licenses received from the Ministry of Information Industry in connection with our businesses for our benefit. The government currently does not charge license fees for the telecommunications licenses held by China Telecom Group. To the extent the government begins to charge such fees in the future, we will likely share the cost with China Telecom Group. In addition, we may not be able to benefit from the licenses held by China Telecom Group if we cease to remain its controlled subsidiary. See Item 7. Major Shareholders and Related Party Transactions B. Related Party Transactions.

In 2002, we successfully completed our initial public offering of H shares and raised approximately RMB10,659 million in aggregate net proceeds for us. Upon completion of our initial public offering, our shares became listed on the Hong Kong Stock Exchange and ADSs representing our H shares are listed and traded on the New York Stock Exchange.



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The following chart sets forth our corporate organization and shareholders prior to the acquisition in 2003:

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(1) The percentages may not add up to 100% due to rounding discrepancies.

### **Our Acquisition in 2003**

On December 31, 2003, we acquired from China Telecom Group the entire equity interests in each of Anhui Telecom Company Limited, Fujian Telecom Company Limited, Jiangxi Telecom Company Limited, Guangxi Telecom Company Limited, Chongqing Telecom Company Limited and Sichuan Telecom Company Limited and certain network management and research and development facilities. These acquired companies are the leading providers of wireline telecommunications services, including wireline telephone, managed data, Internet and leased line services in Anhui Province, Fujian Province, Jiangxi Province, Guangxi Zhuang Autonomous Region, Chongqing Municipality and Sichuan Province, respectively. The assets, liabilities and operations of these acquired companies had been segregated and separately managed by us since December 31, 2002. As part of the reorganization in preparation of the acquisition, China Telecom Group has undertaken to indemnify these companies for any loss or damages suffered by them as a result of, or related to, the reorganization and/or in connection with events preceding the reorganization.

The purchase price of the acquisition amounted to RMB46 billion. Of the purchase price, we paid an initial consideration of RMB11 billion in cash upon the completion of the acquisition. The deferred consideration of the remaining RMB35 billion is payable on December 31, 2013. We may prepay all or, from time to time, a part of the deferred consideration at any time within a ten-year period without penalty. We will pay interest to China Telecom

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Group at semi-annual intervals on the actual amount of the deferred consideration remaining outstanding at an annual rate of 5.184% for the first five years after December 31, 2003. This rate will be adjusted on the fifth anniversary of the completion of the acquisition on December 31, 2003 based on the then current Renminbi lending rate of the Chinese commercial banks for loans with tenure of more than five years. In 2004, we paid China Telecom Group approximately RMB1,814 million interest on the deferred consideration for our acquisition in 2003.

In connection with this acquisition and as part of the reform plan of rural telecommunications services, China Telecom Group agreed to transfer to Fujian Electronic Information (Group) Co., Ltd., a state-owned enterprise owned by the provincial governments of the Fujian Province, 977,004,913 of our domestic shares. Since China Telecom Group sold 462,749,683 shares in our global offering in 2004, the shares it agreed to transfer to Fujian Electronic Information (Group) Co., Ltd. has decreased to 969,317,182 shares accordingly, which represents approximately 1.45% of our total issued domestic shares as of May 23, 2005. Such transfer is subject to a number of conditions precedent and will not be made prior to September 10, 2005.

On December 31, 2003, our Company, together with our wholly-owned subsidiary, Shanghai Telecom Company Limited, acquired from China Telecom Group the entire equity interest in China Telecom Group Yellow Pages Information Company Ltd., or China Telecom Yellow Page. The aggregate consideration of the transaction was RMB25 million, which falls below the de minimis provision under the Listing Rules, and therefore the transaction is exempt from the reporting, announcement and independent shareholders' approval requirements.



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Set out below is our corporate structure immediately after the acquisition in 2003 but prior to the acquisition in 2004:

- 
- (1) The percentages may not add up to 100% due to rounding discrepancies.
  - (2) Denotes the companies acquired pursuant to the acquisition.
  - (3) Includes 977,004,913 of our domestic shares that China Telecom Group agreed to transfer to Fujian Electronic Information (Group) Co., Ltd., a state-owned enterprise owned by the provincial governments of the Fujian Province as part of the reform plan of rural telecommunications services. Due to the sale of certain shares by China Telecom Group in our global offering in 2004, the number of shares to be transferred has decreased to 969,317,182 shares after our global offering in 2004, which represents approximately 1.45% of our total issued domestic shares as of May 23, 2005. Such transfer is subject to a number of conditions precedent and will not be made prior to September 10, 2005.
  - (4) On December 31, 2003, our Company, together with our wholly-owned subsidiary, Shanghai Telecom Company Limited, acquired from China Telecom Group the entire equity interest in China Telecom Group Yellow Pages Information Company Ltd., which is not shown in the chart above. The aggregate consideration of the transaction was approximately RMB25 million, which falls below the de minimis provision under the Listing Rules, and therefore the transaction is exempt from the reporting, announcement and independent shareholders approval requirements.

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### **Our Acquisition in 2004**

On June 30, 2004, we acquired from China Telecom Group its entire equity interests in each of Hubei Telecom Company Limited, Hunan Telecom Company Limited, Hainan Telecom Company Limited, Guizhou Telecom Company Limited, Yunnan Telecom Company Limited, Shaanxi Telecom Company Limited, Gansu Telecom Company Limited, Qinghai Telecom Company Limited, Ningxia Telecom Company Limited and Xinjiang Telecom Company Limited. These acquired companies are providers of wireline telecommunications services, including wireline telephone, Internet and managed data and leased line services in Hubei province, Hunan province, Hainan province, Guizhou province, Yunnan province, Shaanxi province, Gansu province, Qinghai province, Ningxia Hui Autonomous Region and Xinjiang Uygur Autonomous Region, respectively.

The purchase price of the acquisition amounted to RMB27.8 billion. Of the purchase price, we paid an initial consideration of RMB8.34 billion in cash upon the completion of the acquisition. The deferred consideration of the remaining RMB19.46 billion is payable on June 30, 2014. We may prepay all or, from time to time, a part of the deferred consideration at any time within a ten-year period without penalty. From June 30, 2004, we will pay interest to China Telecom Group at half-yearly intervals on the actual amount of deferred consideration remaining outstanding. Interest will accrue daily and, for the first five years after June 30, 2004, will be payable at the rate of 5.184% per year, being 10% discount to the RMB lending rate of 5.76% per year of commercial banks in the PRC in respect of loans with tenure of more than five years as published by the People's Bank of China and prevailing at 12:00 noon (Beijing time) on April 8, 2004, being the business day immediately preceding the day of the execution of the acquisition agreement. Thereafter, the interest rate will be adjusted on June 30, 2009 to the then RMB lending rate of a commercial bank loan of similar amount and tenure with the same discount. On June 30, 2004, we repaid RMB4,310 million of this payable amount using the net proceeds from issue of new H shares in May 2004. In 2004, we paid China Telecom Group approximately RMB393 million interest on the deferred consideration.

In preparation for this acquisition, Hubei Telecom Company Limited, Hunan Telecom Company Limited, Hainan Telecom Company Limited, Guizhou Telecom Company Limited, Yunnan Telecom Company Limited, Shaanxi Telecom Company Limited, Gansu Telecom Company Limited, Qinghai Telecom Company Limited, Ningxia Telecom Company Limited and Xinjiang Telecom Company Limited were all incorporated in March 2004, each as a wholly-owned subsidiary of China Telecom Group. China Telecom Group's telecommunications operations in Hubei province, Hunan province, Hainan province, Guizhou province, Yunnan province, Shaanxi province, Gansu province, Qinghai province, Ningxia Hui Autonomous Region and Xinjiang Uygur Autonomous Region, together with related assets and liabilities were transferred to the respective acquired companies. The assets, liabilities and operations of these companies have been segregated and separately managed since December 31, 2003. As part of the reorganization in preparation of the acquisition, China Telecom Group has undertaken to indemnify these companies for any loss or damages suffered by them as a result of, or related to, the reorganization and/or in connection with events preceding the reorganization.

### **Our Global Offering in 2004**

In May 2004, we issued 5,318,181,818 new H shares with a par value of RMB1.00 each, representing 4,466,693,018 H shares and 8,514,888 ADSs, each representing 100 H shares, at prices of HK\$2.30 per H share and US\$29.49 per ADS, respectively, by way of a global offering to Hong Kong and overseas investors. We raised net proceeds of RMB12,702 million from this issuance of new H shares. On June 30, 2004, we used RMB12,650 million of the net proceeds from this issuance to make a cash payment for the acquisition of 2004, i.e., RMB8,340 million as the initial consideration and RMB4,310 million as part of the deferred consideration. As part of the global offering, 531,818,182 existing domestic shares of RMB1.00 each owned by China Telecom Group and our other domestic shareholders were converted into H shares and sold to Hong Kong and overseas investors.

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Set out below is our corporate structure immediately after the acquisition in 2004 and as of May 23, 2005:

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- (1) The percentages may not add up to 100% due to rounding discrepancies.
- (2) Includes 969,317,182 of our domestic shares (representing approximately 1.45% of our total issued domestic shares as of May 23, 2005) that China Telecom Group has agreed to transfer to Fujian Electronic Information (Group) Co., Ltd., a state-owned enterprise owned by the provincial governments of the Fujian Province as part of the reform plan of rural telecommunications services. Such transfer is subject to a number of conditions precedent and will not be made prior to September 10, 2005.
- (3) Denotes the companies acquired pursuant to the acquisition in 2004.
- (4) On December 31, 2003, our company, together with our wholly-owned subsidiary, Shanghai Telecom Company Limited, acquired from China Telecom Group the entire equity interest in China Telecom Group Yellow Pages Information Company Ltd., which is not shown in the chart above. The aggregate consideration of the transaction was approximately RMB25 million, which falls below the de minimis provision under the Listing Rules, and therefore the transaction is exempt from the reporting, announcement and independent shareholders approval requirements.

## **General Information**

Our principal executive offices are located at 31 Jinrong Street, Xicheng District, Beijing, China 100032 and our telephone number is (86-10) 6642-8166. Our website address is [www.chinatelecom-h.com](http://www.chinatelecom-h.com). The information on our web site is not a part of this annual report. We have appointed CT Corporation System at 111 Eighth Avenue, New York, New York 10011 as our agent for service of process in the United States.

## **B. Business Overview**

We are the leading provider of wireline telecommunications services in our service regions in China. Our service regions consist of Anhui Province, Chongqing Municipality, Fujian Province, Gansu Province, Guangdong Province, Guangxi Zhuang Autonomous Region, Guizhou Province, Hainan Province, Hubei Province, Hunan Province, Jiangsu Province, Jiangxi Province, Ningxia Hui Autonomous Region, Qinghai Province, Shaanxi Province, Shanghai Municipality, Sichuan Province, Xinjiang Uygur Autonomous Region, Yunnan Province, Zhejiang Province. Our scope of business includes:

- (1) operating a variety of domestic wireline telecommunications networks and facilities (including wireless local loops);
- (2) providing voice, data, image, multimedia telecommunications and information services based on the wireline networks;
- (3) providing international services and conducting accounts settlement with overseas operators in accordance with state regulations; and
- (4) providing telecommunications and information-related system integration, technological development, technical services, information consulting, and conducting design, manufacture, sales and installation of telecommunications equipment.

Our businesses grew steadily in 2004. Our local telephone subscribers continue to grow at a steady pace. Broadband subscribers maintained strong growth and became a growth driver with increasing importance in our revenue structure. Domestic long distance services recorded both usage and revenue growth and value-added services portfolio was further expanded.

Our operating revenue depends largely on customer base, usage volume and the level and structure of our tariffs. The following table shows our selected operating data as of the dates and for the periods indicated.



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	As of or for the year ended December 31,		
	2002	2003	2004
<b>Local Telephone:</b>			
Access lines in service (in millions)	133.1	161.0	186.7
Total pulses (in billions)	459.3	455.1	466.8
<b>Domestic Long Distance:</b>			
Total outgoing call minutes carried (in billions)	59.5	67.3	82.0
<b>International, Hong Kong, Macau and Taiwan Long Distance:</b>			
Total outgoing call minutes carried (in billions)	1.55	1.67	1.65
<b>Interconnection</b>			
Volume of inbound local call minutes (in billions)	53.5	76.2	94.7
<b>Dial-up Internet Access:</b>			
Number of subscribers (in millions)	24.0	22.2	15.8
Dial-up on-line usage (minutes in billions)	81.6	54.9	30.0
<b>Broadband Access:</b>			
Number of subscribers (in millions)	2.4	7.2	13.8
<b>Managed Data (bandwidth leased in thousands):</b>			
DDN (x64Kbps)	378.2	471.2	493.3
Frame relay (x128Kbps)	48.1	88.3	156.3
ATM (x2Mbps)	16.6	19.0	23.8
<b>Leased Digital Circuits:</b>			
Total bandwidth (x2Mbps) (bandwidth leased in thousands)	164.5	163.1	169.5
<b>Value-added Services</b>			
Caller ID service subscribers (in millions)	51.5	82.5	109.0
Usage of telephone information services (minutes in billions)	0.9	1.7	2.4

The number of our local access lines in service increased by approximately 15.9% from 2003 to 2004. The usage of our local voice services increased by approximately 11.6% from 384.5 billion pulses to 429.2 billion pulses from 2003 to 2004. Subscribers for our broadband access services grew significantly from 7.2 million as of December 31, 2003 to 13.8 million as of December 31, 2004. We expect broadband business to become a key driver of our future growth. We experienced significant growth in value-added services in 2004. The subscriber number of our caller ID services increased by approximately 32.1% from 2003 to 2004. The usage of telephone information services increased by approximately 38.8% from 2003 to 2004. We expect to further capitalize on the market potential of value-added services in the future.

The following table sets forth a breakdown of our operating revenue for 2002, 2003 and 2004:

	For the Year Ended December 31		
	2002	2003	2004
(RMB in millions)			
<b>Wireline telephone services<sup>(1)</sup></b>			
Local			
Installation fees	2,305	2,643	2,865
Monthly fees	25,338	27,499	29,827
Local usage fees	44,440	45,815	47,646
Sub-total	72,083	75,957	80,338
Domestic long distance <sup>(2)</sup>	25,726	25,460	26,231

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International, Hong Kong, Macau and Taiwan long distance <sup>(2)</sup>	3,878	3,943	3,788
Interconnections	7,524	8,365	10,719
Upfront connection fees	10,564	9,771	8,458
	<hr/>	<hr/>	<hr/>
Sub-total	119,775	123,496	129,534
Internet	5,998	10,007	14,109
Managed data	3,147	3,210	3,015
Leased line services	5,520	5,103	4,154
Others <sup>(3)</sup>	6,466	9,737	10,400
	<hr/>	<hr/>	<hr/>
Total operating revenue	140,906	151,553	161,212
	<hr/>	<hr/>	<hr/>

(1) Includes revenue from our registered subscribers, public telephones and prepaid calling cards services.

(2) Includes revenue from our VoIP long distance services.

(3) Includes primarily revenue from the provision of value-added telecommunications services, sale and repairs and maintenance of customer-end equipment, and lease of telecommunications network facilities.

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We believe there is still potential for further growth in China's telecommunications market, due to the growth of China's economy, the broader adoption of information technology and advanced communications services in China. However, with increasingly intensified competition and the further expansion and price fluctuation of mobile services, mobile substitution has become more apparent and adversely affected the growth potential of our wireline telephone service. Therefore, in 2005, our business strategy will focus on transforming from a traditional wireline network operator into a modern integrated information services provider. As part of the strategy, we plan to continue to pursue the operation of mobile business proactively and seek to work with IT service providers to offer differentiated total solutions to enterprise customers. We will fully exploit the development potential of rural telephony, value-added services, leased line and other services.

### ***Wireline Telephone Services***

Our telephone services consist of local telephone, domestic long distance, international, Hong Kong, Macau and Taiwan long distance, value-added voice and information services and interconnection.

Wireline telephone services are our main services, generating 80.3% of our total operating revenue in 2004, compared to 81.5% in 2003. Revenue generated by these services slightly increased from RMB123,496 million in 2003 to RMB129,534 million in 2004.

### ***Local Telephone Services***

Our local telephone services provide the largest revenue source for our wireline telephone services. Revenue derived from our local telephone services in 2004 accounted for 49.8% of our total operating revenue, compared to 50.2% in 2003.

We have expanded our local telephone subscribers and the total number of our subscribers reached 186.7 million at the end of 2004, an increase of 25.7 million, or approximately 15.9% from 2003. Wireless local access service and public telephone service subscribers grew relatively faster. As of the end of 2004, wireless local access service subscribers and public telephone service subscribers reached 42.2 million and 12.4 million, increasing 16.6 million and 2.8 million, or approximately 64.9% and 29.0%, respectively, from 2003. In the local telephone services market, urban residential subscribers growth has slowed down and the subscribers and usage diversion exacerbated, while wireless local access service demand was comparatively stable and the rural telecommunications market exhibited a strong growth potential.



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**Access lines.** The following table sets forth selected information regarding our local telephone subscribers as of the dates indicated:

	As of December 31,		
	2002	2003	2004
	(in millions)		
Residential	98.8	108.1	113.1
Enterprise	16.3	17.7	19.0
Public telephones	7.2	9.6	12.4
Wireless local access	10.8	25.6	42.2
Total	133.1	161.0	186.7

**Service usage.** The following table sets forth certain usage information regarding our local telephone services for the periods indicated:

	Year Ended December 31,		
	2002	2003	2004
Total usage (pulses in billions) <sup>(1)</sup>	459.3	455.1	466.8

- (1) Pulses are the billing units for calculating local telephone usage fees. The definition of a pulse for intra-district calls changed in connection with the tariff adjustments mandated by the Chinese government and implemented by us in 2001. See Tariffs for the respective definitions of a pulse before and after the tariff adjustments in 2001.

Local voice usage reached 429,150 million pulses in 2004, an increase of approximately 11.6% from 2003. As some customers of our dial-up Internet services began to use our broadband Internet services, dial-up Internet usage, including dial-up usage of customers of other Internet service providers, decreased from 70,621 million pulses in 2003 to 37,665 million pulses in 2004, representing a 46.7% decrease. Tariffs for dial-up Internet access were much lower than the usage fees for voice services.

**Tariffs.** For our local telephone services, we charge an upfront installation fee, a fixed monthly fee and local call usage fees based on call duration. The tariffs are regulated by the Chinese government. The local call usage fees are either intra-district or inter-district, depending upon whether a call is within a single service district or between service districts. We implemented the tariff adjustments mandated by the Chinese government in the first half of 2001. The mandated tariff adjustments changed the tariff levels for many telecommunications services, including local and long distance telephone, data and leased line services. See Regulatory and Related Matters Tariff Setting included elsewhere under this Item.

The following table sets forth the changes in our tariffs before and after the tariff adjustments we implemented in 2001 for local telephone services:

Before Tariff Adjustments

After Tariff Adjustments

	(RMB)			
Monthly fee: <sup>(1)</sup>				
Residential customers	7.6	25.0	10.0	25.0
Enterprise customers	12.0	37.0	15.0	35.0
Usage fee:				
Intra-district	0.16	0.22 per pulse (three minute intervals)	0.18	0.22 for the first two pulses (first three minutes or less) and 0.09 0.11 for each additional pulse (one minute intervals)
Inter-district	0.20	0.50 per pulse (one minute intervals)	0.20	0.50 per pulse (one minute intervals)

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	Before Tariff Adjustments	After Tariff Adjustments
	(RMB)	
Communications fee:		
Internet dial-up	0.08 0.11 per pulse (three minute intervals)	0.02 per pulse (one minute intervals)

(1) Monthly fees for customers vary depending on whether a subscriber is located in the provincial capital, a city, a county or rural areas.

Prior to July 2001, we charged an upfront connection fee for basic access services. State guidance rates for connection fees for basic access services varied from time to time and were adjusted from a range of RMB2,500 to RMB5,000 in 1999 to a range of RMB500 to RMB1,000 in 2001, and the connection fees were eliminated entirely in July 2001. The decrease in and ultimate elimination of the connection fees have stimulated customer growth, especially for residential customers. In addition, all previous surcharges on telephone services, which were mostly levied by provincial and local governments, were eliminated in July 2001.

**Domestic Long Distance Services**

Revenue from our domestic long distance services reached RMB26,231 million, an increase of approximately 3.0% from 2003. Total domestic long distance usage was 81,960 million minutes, representing an annual growth rate of approximately 21.8%. Total revenue from our domestic long distance services represented approximately 16.3% of our total operating revenue in 2004, compared to approximately 16.8% in 2003. Our domestic long distance services had a market share of 45.8% as measured by total minutes carried through our networks as calculated based on statistical data from the Ministry of Information Industry, which was down 3.6 percentage points from 2003. In order to improve our revenue in the increasingly competitive market environment for our long distance services market, we adopted a more effective pricing strategy and accelerated the development of public telephone supermarkets. Meanwhile, we further streamlined phone cards distribution channels to divert long distance usage volume from mobile services. Our efforts were rewarded with increases in both domestic long distance usage and revenue.

**Service usage.** The following table shows the total minutes of domestic long distance calls carried through our long distance network for the periods indicated:

	Year Ended December 31,		
	2002	2003	2004
Total minutes of usage (in millions): <sup>(1)</sup>			
Public switched telephone networks	30,367	31,491	39,831
VoIP	29,125	35,821	42,129
<b>Total</b>	<b>59,492</b>	<b>67,312</b>	<b>81,960</b>

(1) Includes calls originated by mobile subscribers that are carried over our long distance networks.

We have commenced providing VoIP services since 1999. The usage of our VoIP domestic long distance services as a percentage of the total usage of domestic long distance services decreased from approximately 53.2% in 2003 to approximately 51.4% in 2004, mainly because of the migration of the customers to mobile telecommunications. However, the average VoIP call duration is generally longer than that of long distance calls using public switched telephone networks. We provide VoIP services primarily to price sensitive customers, such as small businesses, certain residential customers and non-resident persons. We offer our VoIP services selectively to small businesses or other non-resident persons

in response to market demand and offer flexible VoIP service packages in response to competition.

**Tariffs.** The tariff adjustments that we implemented in 2001 abolished the distance-based tariff structure, reduced the unit of billing from one minute to six seconds and eliminated long distance call surcharges.

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The following table sets forth the tariffs for our domestic long distance telephone services before and after the tariff adjustments in 2001, which are based on state tariff rates:

	Before Tariff Adjustments	After Tariff Adjustments
		(RMB)
Public switched telephone network services		All at the unified rate of 0.07 per six seconds <sup>(1)</sup>
Intra-provincial less than 300 km	0.50-0.60 per minute <sup>(2)</sup>	
Intra-provincial more than 300 km	0.60 per minute <sup>(2)</sup>	
Inter-provincial less than 800 km	0.80 per minute <sup>(2)</sup>	
Inter-provincial more than 800 km	1.00 per minute <sup>(2)</sup>	
VoIP services <sup>(3)</sup>	0.30 per minute	Not regulated

- (1) A discount rate of up to 40% applies to calls made during off-peak hours, which are from 12:00 am to 7:00 am every day.
- (2) A discount rate of 50% applies to calls made during off-peak hours, which are from 9:00 pm to 12:00 am for weekdays and from 7:00 am to 12:00 am on public holidays and weekends; a discount rate of 70% applies to calls made during 12:00 am to 7:00 am everyday.
- (3) Does not include separate usage fees for local services when a VoIP call is placed. The local usage fee of a VoIP call is the same as the local usage fee of an intra-district local voice call.

VoIP long distance services are charged at lower tariff rates than those for long distance services using public switched telephone networks. However, we also charge local usage fees on VoIP long distance calls. The tariff adjustments in 2001 deregulated the tariffs for VoIP services, which provides us the flexibility in setting tariffs for our VoIP services.

***International, Hong Kong, Macau and Taiwan Long Distance Services***

Revenue from our international, Hong Kong, Macau and Taiwan long distance services amounted to RMB3,788 million in 2004, down approximately 3.9% from 2003. Usage in 2004 was 1,654 million minutes, approximately the same level as 2003. Our market share in this sector was 56.3% as measured by total minutes carried through our networks as calculated based on statistical data from the Ministry of Information Industry, 4.9 percentage points down from 2003. Nevertheless, we maintained our leading position in this market. Our international, Hong Kong, Macau and Taiwan long distance telephone services contributed approximately 2.3% to our total operating revenue in 2004, compared to approximately 2.6% in 2003. We also provide VoIP international, Hong Kong, Macau and Taiwan long distance services, similar to our VoIP domestic long distance services in our service regions.

**Service usage.** The following table sets forth certain information related to the usage of our international, Hong Kong, Macau and Taiwan long distance services, including usage of international, Hong Kong, Macau and Taiwan long distance services by mobile subscribers, for the periods indicated:

	Year Ended December 31,		
	2002	2003	2004
Outgoing call minutes (in millions) <sup>(1)</sup> :			
Public switched telephone networks	793	1,015	632

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VoIP	753	655	1,022
Total	1,546	1,670	1,654

(1) Includes calls originated by subscribers of other operators that are carried through the international gateways of China Telecom Group.

**Tariffs.** The tariff adjustments in 2001 reduced the basic unit of billing from one minute to six seconds and simplified the rate schedule by abolishing the distance-based tariff structure. The following table sets forth our international, Hong Kong, Macau and Taiwan long distance tariffs before and after the tariff adjustments:

	Before Tariff Adjustments		After Tariff Adjustments	
	(RMB)			
Public switched telephone networks services:				
To Hong Kong, Macau and Taiwan	2.55	5.00 per minute <sup>(1)</sup>	0.20	per 6 seconds
To all international destinations	5.30	15.00 per minute <sup>(2)</sup>	0.80	per 6 seconds <sup>(3)</sup>
VoIP services: <sup>(4)</sup>				
To Hong Kong, Macau and Taiwan	1.50	2.50 per minute	1.50	per minute
To all international destinations	2.40	4.80 per minute	2.40 - 4.60	per minute

- (1) A discount rate of 40% applies to calls made during off-peak hours.
- (2) Rates of RMB5.30-12.00 per minute apply to calls made to Asian countries and regions and a rate of RMB15.00 per minute applied to calls to all other international destinations. A discount rate of 40% applied to calls made during off-peak hours.
- (3) A discount rate of up to 40% applies to calls made during off-peak hours.
- (4) Does not include separate usage fees for local services when a VoIP call is placed. The local usage fee of a VoIP call is the same as the local usage fee of an intra-district local voice call.

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Since the tariff adjustments in 2001, we charge RMB 1.50 per minute for VoIP long distance calls to Hong Kong, Macau and Taiwan and RMB 2.40-4.60 per minute for VoIP long distance calls to international destinations, but offer various incentive programs and discounts from time to time.

We offer international, Hong Kong, Macau and Taiwan long distance services through the international gateways of China Telecom Group. China Telecom Group negotiates bilateral settlement arrangements and rates based on the international settlement standards in the telecommunications industry, and those settlement arrangements and rates also apply to us.

### ***Value-added Voice and Information Services***

In addition to basic local and long distance voice services, we offer a variety of value-added voice and information services. Significant usage growth of our value-added services in 2004 contributed to our overall revenue growth.

***Value-added voice services.*** Our value-added voice services include caller ID, call forwarding, conference call and toll-free services. Subscribers of our caller ID services reached 109 million, with a penetration rate of 58.4%, by the end of 2004, an increase by 7 percentage points from 2003. Based on our extensive network resources, customer base and distribution channels, we cooperate with other service providers and continue to develop new value-added voice services. In recent years, we gradually introduced new services such as call-center out-sourcing, video conferencing, direct dial VoIP services with a pre-set access number of 17901, wireline chat room called Telephone QQ, wireline short messaging services and PHS short messaging services. We also launched a service called Color Ring Tone in 2004. We intend to develop this service to meet the existing and potential PHS subscribers' demands. We also expect the revenue generated by this service to grow in line with our existing and potential PHS subscribers' increasing usage of this service. Through our intensive marketing efforts, our customers became familiar with these services and increased their usage. We believe that these value-added voice services allow us to enhance customer satisfaction and increase our revenue. As subscribers in our service regions become more accustomed to these value-added voice services, we believe there is significant growth potential in these areas.

***Telephone information services.*** We have significantly expanded the scope of our automated and operator-assisted telephone information and applications services in recent years. Our general information services allow users to access information at our standard telephone usage rates plus information usage fees. We also provide other specialized telephone information and application services, such as telephone banking, telephone advertising, telephone lottery and telephone stock trading services. Total usage of our telephone information services was 2,419 million minutes in 2004, an increase of approximately 38.8% from 2003. We intend to further expand the scope and usage of these services and develop flexible revenue sharing arrangements with content and application service providers.

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**Telephone directory services.** We publish telephone directories, known as Yellow Pages, in our service regions. In addition, we have introduced online yellow pages and other related information services. We derive advertising revenue from our printed and on-line yellow pages services.

**Tariffs.** Value-added voice and information services are classified as market-based for purpose of tariff determination by relevant regulatory authorities. See Regulatory and Related Matters Tariff Setting. We determine tariffs for our value-added voice and information services according to market conditions. Tariffs for these services vary to a large extent based on types of services and geographical locations.

## ***Interconnection***

Interconnection services accounted for approximately 6.6% of our total operating revenue in 2004. Under relevant regulations, we are exempt from any interconnection payment for outbound local traffic to mobile operators. See Regulatory and Related Matters Interconnection for tariff details. As a result of our continuously expanding customer base and the growing Chinese telecommunications industry, the volume of inbound local calls through our networks reached 94,747 million minutes in 2004, an increase of 24.3% from 2003. The volume of inbound long distance calls also recorded an increase.

We have interconnection arrangements with other telecommunications operators, including China Telecom Group, China Netcom Group, China Mobile and China Unicom. All interconnection and settlement arrangements among public wireline telephone, mobile, and Internet networks in China are governed by the Telecommunications Regulations and the rules on interconnection arrangements and settlement promulgated by the Ministry of Information Industry. See Regulatory and Related Matters Interconnection included elsewhere under this item.

China Telecom Group entered into interconnection agreements with other telecommunications service providers in Shanghai Municipality, Guangdong Province, Jiangsu Province and Zhejiang Province, prior to our incorporation in 2002, with other telecommunications service providers in Anhui Province, Fujian Province, Jiangxi Province, Guangxi Zhuang Autonomous Region, Chongqing Municipality and Sichuan Province, prior to our acquisition in 2003 and with other telecommunications service providers in Hubei province, Hunan province, Hainan province, Guizhou province, Yunnan province, Shaanxi province, Gansu province, Qinghai province, Ningxia Hui Autonomous Region and Xinjiang Uygur Autonomous Region prior to our acquisition in 2004. These agreements provide for interconnection settlement with respect to local calls and domestic and international, Hong Kong, Macau and Taiwan long distance calls involving our networks. In connection with our initial public offering in 2002 and the acquisitions in 2003 and 2004, China Telecom Group has assigned to us, and we have assumed, its rights and obligations under these agreements in relation to our service regions. We also entered into an interconnection agreement with China Telecom Group. The economic terms and the settlement procedures under that agreement are in accordance with the standards set forth in the interconnection rules and regulations, which are described in more details under Regulatory and Related Matters Interconnection included elsewhere under this item. See also Item 7. Major Shareholders and Related Party Transactions B. Related Party Transactions Apportionment of International Settlement; Ongoing Related Party Transactions between Us and China Telecom Group Interconnection Agreement.

## ***Internet and Managed Data Services***

We intend to strategically expand our Internet services. Revenue from Internet services was RMB14,109 million in 2004, an increase of approximately 41.0% from 2003 and represented approximately 8.8% of our total operating revenue. Broadband business became a key strategic driver for our sustainable development. In 2004, our broadband subscribers grew by 6.6 million or 91.4% from the end of 2003 to 13.8 million in 2004, further consolidated our leading position in the broadband access service market in our service regions.





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The following table sets forth selected information regarding our Internet, managed data and related services as of the dates or for the periods indicated:

	As of or for the Year Ended December 31,		
	2002	2003	2004
<b>Dial-up Internet access services:</b>			
Dial-up subscribers (in thousands)	24,020	22,163	15,824
Dial-up on-line usage (minutes in millions)	81,648	54,886	30,046
<b>Broadband access services (in thousands):</b>			
DSL subscribers	1,718	5,229	10,000
FTTx + LAN subscribers	674	1,975	3,716
Others	19	28	122

***Dial-up Internet Access Services***

We classify our dial-up Internet access users into registered users, non-registered users and prepaid users. In addition, we provide Internet transit and access services to some international and domestic telecommunications operators. We also provide many business customers with direct fiber optic links between their local area networks and the Internet.

Our dial-up Internet access subscribers decreased by approximately 28.6%, from approximately 22.2 million as of December 31, 2003 to approximately 15.8 million as of December 31, 2004. Total usage of our dial-up Internet access services by our subscribers decreased from 54,886 million minutes in 2003 to 30,046 million minutes in 2004, or approximately 45.3%. We believe the decline was mainly due to migration of customers from our dial-up Internet services to our broadband Internet services.

**Tariffs.** Registered dial-up Internet access users pay an Internet access fee as well as local communications fees. In 2003, the Ministry of Information Industry liberalized the tariff regulations and lifted state guidance tariffs for Internet services. Currently, there are no pre-set tariff rates promulgated by the Chinese government or other regulatory authorities on Internet services.

***Broadband Internet Access***

We began offering broadband Internet access services in 2000. In 2004, our broadband subscribers maintained its strong growth and became a revenue growth driver with increasing importance in our revenue structure. Our broadband subscribers grew by 6.6 million or 91.4% from the end of 2003 to 13.8 million in 2004.

**DSL services.** In 2004, we continued to leverage on our dominant position in local access networks, extensive distribution network and high quality customer services in promoting our DSL services. We promote DSL services as the primary broadband Internet access means for our residential customers and small- and medium-sized enterprise customers. DSL services can be offered over existing copper wires and are suitable for high-speed Internet access. We had approximately 5 million DSL subscribers as of December 31, 2003 and approximately 10 million

DSL subscribers as of December 31, 2004.

***Fiber-Ethernet access services.*** We offer broadband access services through fiber optic cables that directly link Ethernet technology-based LANs in office buildings or high-end residential complexes to the Internet. Fiber-Ethernet access uses optic fiber technology and Ethernet protocol to connect residential users and business users to a telecommunications network and greatly expands capacity of the access network. As of December 31, 2003 and 2004, we had approximately 1.9 million customers and 3.7 million customers, respectively, using fiber-Ethernet access services.

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**Broadband application services.** We continue to leverage our broadband access networks and distribution channels to develop various broadband application services such as distance education, distance medical services, video conferencing, on-line games, entertainment and video-on-demand services.

Based on our large subscriber base, network resources, application platforms and reliable supporting systems, as well as our customer management and billing system, we cooperated with other service providers and launched ChinaVnet in 2003 to promote our broadband Internet access services. ChinaVnet offers billing platforms and channels for Internet content and application providers and provides subscribers with convenient access to the comprehensive content and application services provided by those service providers. We believe that the introduction of ChinaVnet will stimulate growth in the subscriber base and revenue from our broadband Internet services.

In 2003, we introduced a service known as *Broadband New Vision*, which is a multimedia service that allows the transmission of video, voice and data over our Broadband access networks. In addition, we provide to our key customers tailored total solutions based on our broadband and data networks. For example, we cooperated with the customs departments in our service regions and launched a service called *e-Customs*. The *e-Customs* service provides our Internet users with customs clearance services and certain other import and export related services over the Internet. Since 2004, we have commenced conducting research on the technology and business models in the IPTV business. We may form alliance with content providers to supply IPTV programs. In addition, we expect to cooperate with television manufacturers to upgrade our telephone terminals in order to realize the integration of television, broadband and voice service.

**Tariffs.** Internet services are classified as *market-based* for purpose of tariff determination by relevant regulatory authorities. See *Regulatory and Related Matters* *Tariff Setting*. We determine tariffs for dial-up and broadband services according to market conditions. Tariffs for these services vary to a large extent based on types of services and geographical locations.

### ***Managed Data Services***

Our managed data services include Digital Data Network, or DDN, frame relay, or FR, and Asynchronous Transfer Mode, or ATM, services. In 2004, we continued to focus on government, financial and large enterprise customers. Our marketing efforts focused on providing global one-stop shopping, tailored services and comprehensive solution packages to these customers. Our customers can enjoy a full range of consulting, trouble-shooting, billing and collection, and technical support services by contacting any designated account manager in our company.

**DDN services.** The bandwidth volume of our DDN services grew by approximately 4.7% in 2004. Our DDN services provide high-quality and reliable transmission at speeds ranging from 64Kbps to 2Mbps and continue to meet the increasing demand for low- to medium-speed transmission capacity from enterprise customers. DDN systems are composed of optic fibers, digital transmission paths and digital cross multiplexing nodes. DDN systems are capable of providing high-quality private circuits and other services at various data rates to satisfy users multimedia communications needs.

**Frame relay/ATM services.** The bandwidth volume of our frame relay and ATM services grew by approximately 77.0% and 25.3%, respectively, in 2004. We offer advanced high-speed data communications services based on frame relay and ATM technologies. These services enable flexible and cost-effective usage of bandwidth resources. Frame relay is a type of connection-oriented packet switching technology that employs statistical multiplexing over a shared network. Frame relay offers both access to a network and transmission of data across a network and is used by customers with significant amounts of data traffic. ATM is a high bandwidth and multiplexing technology. ATM is developed for high data rates with a high quality of service, and can offer integrated voice, data and video services at various data rates.

We offer these services as part of our total telecommunications solutions to large enterprise customers, including government agencies, large corporations and institutions. Many of these customers choose frame relay and

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ATM services to form VPNs and link their local area networks at different locations. We also collaborate with a number of international telecommunications service providers to build global communications networks for multinational corporations.

**Tariffs.** We determine most of the tariffs for our data services within a price range set by the Chinese government. We generally charge an upfront fee for installation and testing for our data services and a fixed monthly fee. We offer various incentive programs and discounts for our customers who wish to upgrade to higher bandwidth services. These incentive programs and discounts have stimulated demand for our managed data services in recent years.

The following table sets forth the monthly fees for DDN services at the bandwidth of 64Kbps and 2Mbps for the periods indicated:

	Monthly Fee		
	2002	2003	2004
	(RMB)		
<b>64Kbps</b>			
Intra-district	1,500	1,500	1,500
Inter-district	2,000	2,000	2,000
Intra-provincial	3,500	3,500	3,500
Inter-provincial	3,500	3,500	3,500
<b>2Mbps</b>			
Intra-district	6,000	6,000	6,000
Inter-district	8,000	8,000	8,000
Intra-provincial	12,000	12,000	12,000
Inter-provincial	12,000	12,000	12,000

The following tables set forth the monthly fees in 2004 for frame relay and ATM services, which include monthly fees for port access and permanent virtual circuits, or PVCs:

Bandwidth	Monthly Fee for Port Access			
	2Mbps	10Mbps	100Mbps	155Mbps
	(RMB)			
Monthly fees	1,000	5,000	9,000	10,000

PVC monthly fees (RMB):<sup>(1)</sup>

Bandwidth	PVC Monthly Fees		
	Intra-District	Inter-District	Domestic Long Distance
	(RMB)		

256Kbps	800	1,150	2,200
2Mbps	1,500	2,200	4,000
10Mbps	5,000	11,500	15,500
155Mbps	14,500	39,000	130,000

(1) One-way tariff for PVC circuits of ATM services.

*System Integration and Other Value-added Services*

We offer system integration and solution services to our customers. Our system integration services encompass initial consulting, network planning, network implementation, application development and maintenance. Our current development focuses on system integration and information management such as network management and data mining and analysis services.

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In 2004, we also launched Short Message Services over PHS, or SMS over PHS service. Usage of SMS over PHS grew rapidly after achieving interconnection with other wireline and mobile services operators, presenting a market potential for further growth.

**Leased Line Services**

We also provide domestic and international leased line services in our service regions. We offer these services as part of our total telecommunications solutions and market these services to large enterprise customers and other operators through our large enterprise customer service teams. In addition to leased lines, we also lease other network elements to business and government customers and other telecommunications service providers. We mainly lease digital circuits, digital trunk lines and optic fibers. The revenue from our leased line services is mainly derived from the lease of domestic and international digital circuits. Revenue from our leased line services was RMB4,154 million in 2004, a decrease of approximately 18.6% from 2003, mainly due to the decrease in prices. As of the end of 2004, we leased out a total of 169.5 thousand digital circuits (in 2Mbps equivalent), an increase of approximately 3.9% from 2003.

The following table sets forth the total amounts of bandwidth of our leased line service as of the end of the year indicated:

	2002	2003	2004
	_____	_____	_____
<b>Leased Digital Circuits</b>			
Total bandwidth (x2Mbps) (thousand)	164.5	163.1	169.5

**Tariffs.** We charge monthly fees for leased lines based on tariff rates set by the Chinese government, which vary based on bandwidth and whether the leased line is local or long distance. Leased line tariffs have generally decreased in recent years. The tariff adjustments in 2001 substantially reduced tariffs for leased line services.

The following table sets forth the tariffs for 2Mbps and 155Mbps digital circuits for the periods indicated:

	Monthly Fee		
	2002	2003	2004
	_____	_____	_____
	(RMB)		
<b>2Mbps</b>			
Intra-district	2,000	2,000	2,000
Inter-district	4,000	4,000	4,000
Intra-provincial <sup>(1)</sup>	6,000	6,000	6,000
Inter-provincial <sup>(1)</sup>	6,000	6,000	6,000
<b>155Mbps</b>			
Intra-district	44,000	44,000	44,000
Inter-district	88,000	88,000	88,000
Intra-provincial <sup>(1)</sup>	132,000	132,000	132,000
Inter-provincial <sup>(1)</sup>	132,000	132,000	132,000



- (1) Does not include the tariffs for local digital circuits and access lines.

*Marketing, Distribution and Customer Services*

*Marketing Initiatives*

We market all of our telecommunications services under the "China Telecom" brand name, which is one of the best known brand names in China. We offer a full range of differentiated services to our customers to address their telecommunications needs. Based on customer segmentation, we have implemented various promotion measures, in particular packaging our services and providing a variety of tariff plans, to mitigate our loss of local voice service usage. Moreover, in order to meet customers' increasingly diversified demands for telecommunications services, we have further optimized our products and services development and marketing mechanisms, and established a "total solution" service system for major customers. We believe these measures have facilitated our business.

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transformation from a provider of telecommunications network services to an integrated telecommunications solutions provider. As a result, we also believe that we have increased our responsiveness to the market and our service quality. In addition, in 2004, we established our China Telecom brand strategy to enhance customer awareness of our available services.

### ***Sales, Distribution and Customer Services***

***Dedicated customer manager system for large enterprise customers.*** We have implemented a large enterprise customer manager system. Under this system, our dedicated customer managers directly market our services to large enterprise customers. These customer managers form dedicated management teams based on the industry background or geographical locations of the customers. We conduct periodic performance reviews and evaluations of the performance of the customer managers based on several factors, including revenue growth, market share, customer satisfaction and customer retention. As of December 31, 2004, we had 9,298 managers for major customers, 10,405 managers for corporate customers nationwide.

***Community manager system.*** We offer integrated sales and maintenance services to small- and medium-sized enterprise customers through our community manager system and divide their community coverage responsibilities by geographical area. Our community managers are responsible for customer development and customer care. We link their compensation mainly to the voice traffic in their coverage areas. In addition, our community managers are also responsible for gathering market and demand information. As of December 31, 2004, we had 38,304 managers for community customers nationwide.

***Contract system in rural areas.*** Under this system, we select certain local residents to be responsible for service promotion, customer development, equipment maintenance and fee collection. This system enables us to lower operational costs effectively while at the same time satisfying the needs of our rural customers.

***Customer service hotlines.*** We provide customer services through our customer service hotlines with the uniform access number of 10000. Our customer service hotlines offer uniform electronic-based services to our residential and enterprise customers. Our customer service hotlines handle service inquiries and service applications, collect bill payments and handle customers' complaints.

***Billing services.*** We bill our residential customers on a monthly basis and provide a range of payment choices for the convenience of our customers, including direct-debit service, which automatically deducts the monthly payment from the subscriber's designated bank or postal account. We also provide specially tailored billing and collection services to our large enterprise customers to help them more effectively plan and monitor their telecommunications needs.

***Marketing and sales agencies and other wholesale channels.*** We market our services through our own retail outlets as well as agents and distributors. Our cooperation with third party agencies and distributors helps us reach a broader customer base and reduce our operating expenses. We provide a range of wireline telecommunications services, including, among others, local and long distance telephone and data services, to government agencies and regulatory authorities at all levels as well as to many state-owned enterprises in our service regions. A number of these government entities and state-owned enterprises are among our largest customers, and the amount of revenue received from entities controlled by the PRC government during 2004 was material to us. We provide these services in the normal course of business.

### ***Precision Management***

To ensure our successful business transformation, we will implement precision management at all levels of the Company. We will adopt quantitative standards to reduce data deviations in all aspects of management on an integrated basis covering marketing activities, network operations, allocation of financial resources and management of human resources.

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### ***Network System***

We were able to realize significant economies of scale as a result of the extensive coverage and scale of our network. It employs a variety of advanced technologies and suitable architecture and can be efficiently migrated to the next generation of network technology. Our network system is managed and operated by our experienced network management and maintenance teams and offers flexible functionality and reliable operation. It supports a comprehensive range of end-to-end wireline telecommunications services and enables customized products to be delivered for a variety of telecommunications needs. Our networks and services are supported by our strong research and development capabilities. We have formulated viable plans in light of future advances in technology to migrate our network system smoothly to the next generation of network technology in order to protect our existing investments.

### ***Network Architecture***

Our network system consists of transport networks, service networks, an application layer and support networks.

*Transport networks:* Transport networks provide the transport functions of voice and data signals for all of our services.

*Service networks:* Service networks include our wireline telephone network, data networks, Internet network and other service networks such as intelligent networks, and support our basic and value-added telecommunications services.

*Application layer:* The application layer provides the platform for a variety of applications and services such as e-commerce, video-on-demand, and on-line games.

*Support networks:* Support networks include signaling networks, digital synchronous networks and network management systems and support the reliable and effective operation of our networks at all levels.

### ***Network Capacity and Technology***

***Local access networks.*** We own extensive local access networks in our service regions. As of December 31, 2004, our local access networks covered all cities, counties and most rural villages in our service regions. As part of our strategic focus on the broadband and PHS network in order to optimize our network and improve utilization, we continue to expand our broadband local access networks utilizing our existing copper line resources and optimizing our PHS network. As of December 31, 2004, the total capacity of our DSL access ports reached 16.9 million lines. At the same time, we are selectively connecting additional large office buildings and business centers with fiber optic access. We also developed wireless LANs in certain business areas in major cities, including hotels, airports, cafes and office buildings to provide business travelers with broadband access services.

***Transport network.*** Our transport system is based on an advanced, high-speed, large-capacity, secure and reliable fiber optic network throughout our service regions. Our fiber optic transport network is also supplemented by satellite transmissions and digital microwave links. Our fiber optic network had a total cable length of 1.1 million kilometers in our service regions as of December 31, 2004.

**Wireline telephone networks.** Our wireline telephone network has been substantially built in the last decade utilizing digital technology. As of December 31, 2004, the total capacity of local switches reached approximately 251.8 million lines and the capacity of long distance switches reached approximately 5.0 million lines. In addition, China Telecom Group has built international gateways in Shanghai and Guangzhou and we utilize these international gateways for our international, Hong Kong, Macau and Taiwan long distance telephone services.

In developing our wireline telephone networks, we have adopted technologies that enable high capacity and fewer exchanges to reduce our construction and operating costs. We have installed advanced intelligent networks

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over our telephone networks. Intelligent networks combine advanced computer technologies with traditional switching techniques to provide flexible value-added services such as prepaid services, virtual private network services and toll free call services. As of December 31, 2004, the utilization rate of local and long distance switches were approximately 76.5% and 74.3%, respectively.

***Internet and managed data networks.*** We have developed a large-capacity, high-quality, reliable and extensive Internet and managed data network system in our service regions. Our Internet and managed data networks allow us to provide services both at the network layer, such as Internet access, managed data and virtual private network services, and at the application layer, such as Internet data center, e-commerce and video-on-demand services.

Our data network system includes a DDN network, a frame relay network and an ATM network. These networks cover all cities and counties in our service regions. Our ATM network allows multi-service access and flexible bandwidth management and provides high-quality, integrated end-to-end services.

Our Internet network is part of ChinaNET. ChinaNET deploys mainstream Gigabyte routers as the main network technology. Most of its backbone routes allow high-speed transmission with the use of several 2.5Gbps circuits.

***Support networks.*** The operation of our wireline telephone, Internet and managed data networks depends on various support networks, including a signaling network based on a signaling technology known as Signaling System 7 protocol, a digital synchronous network and network management systems for various networks and services, such as Internet data center, e-commerce and video-on-demand services.

***Equipment procurement.*** We purchase most of our network equipment from leading international and domestic suppliers. We also purchase from local suppliers a variety of network equipment, such as transport equipment and local switches. We make most of our purchases through competitive tenders primarily based on product and service quality, system compatibility and price.

Our five largest suppliers of telecommunications equipment accounted for approximately 36.6% of our total capital expenditures for 2004. Our largest supplier of telecommunications equipment accounted for approximately 12.9% of our total capital expenditures for 2004.

## ***Information Technology Systems***

As a consistent corporate focus, we continue to improve our operational and management efficiency through the establishment and improvement of our information technology systems. Our information technology systems (CTG-MBOSS) include the business support systems, operation support systems and management information. Adoption of the enterprise application integration technology has allowed for smooth interconnection among all major systems of our company, enabling full information sharing within our company.

Our business support systems (BSS) include our business management system, billing and customer service systems and provide comprehensive and integrated support for various aspects of our business, such as customer relationship management, new service request responses, billing and network error reporting and correction.

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We have developed our operation support systems (OSS) and continue to enhance their functionality. These systems include an integrated network management system and a network resources system, and enable us to enhance network management capabilities, promptly correct network errors and improve resource utilization and network reliability. See Support Networks.

Our management support systems (MSS) include financial information, procurement and human resources management systems. These systems gather and process various operational and financial data for management, marketing and customer service purposes. Operating and financial data gathered by these

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systems allow us to analyze network usage patterns, monitor service quality and customer satisfaction, understand market demand and trends, determine network expansion needs and investment plans and formulate marketing strategies. We are in the process of further improving our management information systems and incorporating them into our enterprise resource planning system.

We believe that the development of our information technology systems will further enhance our market responsiveness and quality of customer services, and will significantly improve our operating efficiency, the management of our business and our competitiveness.

### ***Competition***

We compete with other telecommunications service providers in our wireline telephone, Internet, managed data and leased line services. All of our principal competitors are wholly or majority owned by the Chinese government. The government encourages orderly and fair competition in the telecommunications industry in China. Currently, providers of basic telecommunications services must apply for a license from the Ministry of Information Industry. Only a limited number of providers have obtained licenses to provide basic telecommunications services in China. In China, there are currently two licensed mobile telecommunications service providers, China Mobile and China Unicom, and four wireline service providers, China Netcom Group, China Unicom, China Railcom and us. We face direct and indirect competition from our competitors in all of our businesses within our service regions. During the implementation of our strategy to become an integrated information service provider, we will not only face competition in our traditional wireline service, but also in new services, including mobile telecommunications service. We also expect the level of competition to increase as further deregulation occurs within China's telecommunications industry. See Risk Factors Risk Relating to Our Business We face increasing competition, which may adversely affect our business growth and results of operations. and Regulatory and Related Matters Licensing included elsewhere under this item.

### ***Competition in Wireline Telephone Services***

**Local telephone services.** Mobile service substitution for our wireline telephone services has been the principal competition to our local telephone services. Currently, China Mobile and China Unicom are the only licensed providers of mobile communications services in China. Compared with these mobile service providers, our wireline telephone services continue to offer better voice quality, higher communication consistency, reliability and lower cost, and our wireless local access services also offer mobility within limited local areas. Mobile service providers, however, have the advantages of unrestricted mobility and roaming capability.

Until the mid-1990s, we were the sole licensed wireline local telephone services provider in our service regions. Our local telephone services currently compete with the wireline services offered by China Netcom Group and China Railcom, which have been licensed to provide local telephone services in our service regions. We compete with these operators primarily on the basis of brand name, network coverage, service quality and service offerings. In addition, we have a large customer base, which allows us to compete through economies of scale and to cross-sell our services to our existing customers.

**Long distance telephone services.** We compete with China Unicom, China Railcom and China Netcom Group with respect to long distance telephone services using public switched telephone networks in our service regions. China Unicom and China Railcom are allowed to set their tariffs, subject to annual regulatory approval, for long distance services using public switched telephone networks and are therefore able to offer more competitive prices to customers. In addition, mobile telecommunications services have diverted some of the traffic from our long distance telephone services. We compete with these service providers on the basis of customer base, brand name, network resources, quality of service and marketing and distribution strength. Access to our long distance services does not require the dialing of any pre-set access number or personal identification number.



China Mobile, China Netcom Group, China Unicom, China Railcom and China Satellite provide VoIP services that compete with our public switched telephone network and VoIP long distance services in our service regions. We compete with these VoIP service providers on the basis of customer base, reliability, quality and coverage of

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networks and general service quality. The tariff adjustments in 2001 deregulated the tariffs of VoIP services. This has allowed us to combine price flexibility with bundled services to meet different customer needs and to attract new customers.

### ***Competition in Internet Service***

We compete with other service providers of Internet access services on the basis of customer base, brand name, coverage of access networks and cooperation with the providers of Internet content and applications.

### ***Competition in Managed Data Services***

We compete with China Netcom Group, China Railcom, China Mobile and China Unicom for managed data services. We compete on the basis of end-to-end connectivity, network coverage, service quality and scale efficiency.

### ***Competition in Leased Line Services***

We compete with China Netcom Group, China Unicom and China Railcom in leased line services. We compete with them on the basis of the coverage and quality of networks, ability to provide end-to-end connectivity, quality of network management and customer services.

### ***Competitive Implications of China's Accession to WTO***

Since China's accession to the WTO, foreign operators have been permitted to gradually increase their investments in the telecommunications industry in China. Like domestic service providers, foreign operators are subject to the licensing requirements of the Ministry of Information Industry. In addition, investments by foreign operators may not exceed limits set forth in relevant laws and regulations with respect to the amount of investment and percentage of total investment that foreign operators are permitted to make in telecommunications enterprises in China. For example, the foreign ownership percentage in basic telecommunications services will be subject to a maximum limit of 49%. See Regulatory and Related Matters – Licensing included elsewhere under this item.

Foreign operators may have competitive advantages over us in terms of financial and management resources, network management and technical expertise. On the other hand, because foreign operators currently are prohibited from establishing wholly owned subsidiaries in the telecommunications industry in China, we believe that we are well positioned to establish strategic alliances with strong global operators in this respect. See Item 3. Key Information – D. Risk Factors – Risks Relating to Our Business – We face increasing competition, which may adversely affect our business growth and results of operations.

### ***Trademarks***

We conduct our businesses under the China Telecom brand name and logo. Currently, China Telecom Group owns certain trademarks in China, some of which have been registered with the Trademark Office of the PRC State General Administration for Industry and Commerce, or the Trademark Office, and some of which are in the process of being registered with the Trademark Office. China Telecom Group has executed a trademark license agreement with us. Under this agreement, China Telecom Group agreed to grant to us and our subsidiaries the right to use these trademarks upon the completion of the registration on a royalty-free basis until December 31, 2006, which is automatically renewable for three more years at our option. See Item 7. Major Shareholders and Related Party Transactions B. Related Party Transactions Ongoing Related Party Transactions between Us and China Telecom Group Trademark License Agreement.

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### ***Regulatory and Related Matters***

#### ***Overview***

The telecommunications industry in China is subject to extensive government regulation. A number of central government authorities have regulatory responsibilities for various aspects of the telecommunications industry. These authorities primarily include:

The Ministry of Information Industry, which is responsible for, among other things:

formulating and enforcing industry policies and regulations as well as technical standards;

granting telecommunications service licenses;

supervising the operations and quality of service of telecommunications service providers;

allocating and administering telecommunications resources such as spectrum and numbers;

together with other relevant regulatory authorities, formulating tariff standards for telecommunications services;

formulating interconnection and settlement arrangements between telecommunications networks; and

maintaining fair and orderly market competition among service providers.

Provincial communications administrations under the Ministry of Information Industry, which oversee the implementation of the Ministry's regulations and exercise regulatory authorities delegated by the Ministry within their respective provinces, autonomous regions and centrally administered municipalities.

The National Development and Reform Commission, which, together with the Ministry of Information Industry, sets government fixed tariffs and government guidance tariffs for certain telecommunications services. The actual tariffs charged by providers of telecommunications services are determined by provincial communications administrations, together with the price bureaus of the provinces, autonomous regions or centrally administered municipalities where those providers operate. See [Tariff Setting](#) below. It also approves investment and finance projects exceeding certain capital expenditure amounts as well as foreign investment projects exceeding certain investment amounts.

In order to provide a uniform regulatory framework to encourage the orderly development of the telecommunications industry, the Chinese government is in the process of drafting a telecommunications law. We expect that, if and when the telecommunications law is adopted by the National People's Congress or its Standing Committee, the highest state legislative body in China, it will become the basic telecommunications statute and provide a regulatory framework for the telecommunications industry in China.

*Telecommunications Regulations*

China's State Council promulgated the Telecommunications Regulations, which became effective as of September 25, 2000. The Telecommunications Regulations are substantially consistent with, and are primarily intended to, streamline and clarify the then existing rules and policies for the telecommunications industry. They provide the primary regulatory framework for China's telecommunications industry in the interim period prior to the adoption of the telecommunications law.

The Telecommunications Regulations are intended to develop a transparent and fair regulatory environment to encourage fair and orderly competition and development in the telecommunications industry. The

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Telecommunications Regulations address all key aspects of telecommunications operations, including, among others, entry into the telecommunications industry, network interconnection, telecommunications resource allocation, tariffs and service standards.

**Licensing**

The Telecommunications Regulations adopt the existing regulatory distinction between basic and value-added telecommunications services, which are subject to different licensing requirements. Basic telecommunications services include, among others, wireline local and domestic long distance telephone services, international telecommunications services, IP telephone services, mobile communications services (such as 900/1800MHz GSM, 800MHz CDMA and 3G mobile communications services), satellite communications services, paging services, data communications services (such as Internet data transmission services, international data communications services), network access services and the domestic and international telecommunications facility services. Value-added telecommunications services include, among others, value-added services provided over wireline telephone networks (e.g., telephone information, call center, voice mail and video conferencing services), value-added services provided over mobile networks, value-added services provided over Internet networks (e.g., Internet data center and Internet access and content services) and value-added services provided over other data networks (e.g., computer information, e-mail and electronic data interchange services).

Providers of any basic telecommunications services as well as providers of value-added services in two or more provinces, autonomous regions and centrally administered municipalities in China must apply for licenses from the Ministry of Information Industry. In accordance with the approval of the Ministry of Information Industry, we derive our exclusive rights to operate our businesses from our status as a subsidiary controlled by China Telecom Group, which holds the licenses required for operating our telecommunications businesses.

China's State Council has promulgated the Administrative Regulations on Telecommunications Companies with Foreign Investment, which became effective on January 1, 2002. According to those regulations, enterprises with foreign investment may operate basic and value-added telecommunications businesses subject to the approval of the Ministry of Information Industry and the Ministry of Commerce, formerly the Ministry of Foreign Trade and Economic Cooperation. Certain limitations have been placed on the total registered capital of, and maximum foreign shareholdings in, such enterprises.

The table below summarizes the foreign ownership and geographic restrictions for telecommunications joint ventures in China:

**Foreign Ownership Percentage and Geographic Restrictions  
for Foreign-Invested Telecommunications Enterprises**

Sector	As of December 31,						
	2001	2002	2003	2004	2005	2006	2007
Wireline				25% (3 cities) <sup>(1)</sup>		35% (17 cities) <sup>(2)</sup>	49% (nationwide)
Mobile							

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	25%	35%	49%	49%
	(3 cities) <sup>(1)</sup>	(17 cities) <sup>(2)</sup>	(17 cities) <sup>(2)</sup>	(nationwide)
Value-added	30%	49%	50%	
	(3 cities) <sup>(1)</sup>	(17 cities) <sup>(2)</sup>	(nationwide)	
Paging	30%	49%	50%	
	(3 cities) <sup>(1)</sup>	(17 cities) <sup>(2)</sup>	(nationwide)	

(1) The initial three cities are Beijing, Shanghai and Guangzhou.

(2) The 17 cities are Beijing, Chengdu, Chongqing, Dalian, Fuzhou, Guangzhou, Hangzhou, Nanjing, Ningbo, Qingdao, Shanghai, Shenyang, Shenzhen, Xiamen, Xi'an, Taiyuan and Wuhan.

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The Ministry of Information Industry has promulgated the Measures on Administration of Telecommunication Business Licenses, which became effective on January 1, 2002. Those regulations apply to the application for, and examination and approval of, telecommunications business licenses in China.

The Chinese government has not publicly announced its decisions on issues such as whether it will grant any 3G licenses, and if so, the timing of the grant of the 3G licenses, the number of 3G licenses to be granted, any technical requirements, or any selection of preferred technologies.

### ***Tariff Setting***

The levels and categorization of most of our current tariffs are subject to regulation by various government authorities, including the Ministry of Information Industry, the National Development and Reform Commission, and, at the local level, the relevant provincial communications administrations and price bureaus. Under the Telecommunications Regulations, telecommunications tariffs are categorized into government fixed tariffs, government guidance tariffs and market based tariffs.

Currently, the monthly fee and usage fee for wireline local telephone services are determined by the relevant provincial communications administrations and provincial price bureaus, based on a guidance tariff range set by the Ministry of Information Industry in consultation with the National Development and Reform Commission. Tariffs for all domestic and international long distance services using public switched telephone networks, leased lines and other basic telecommunications services are fixed jointly by the Ministry of Information Industry and the National Development and Reform Commission. Tariffs for telecommunications services in respect of which effective competition has already developed, as determined by the Ministry of Information Industry according to the market conditions, may be set by the service providers. We derive a substantial portion (in excess of 70%) of our revenue from services that are subject to government guidance tariffs and government fixed tariffs. Currently, the Ministry of Information Industry allows tariffs for VoIP, Internet access services and certain value-added services provided over wireline telephone networks, such as telephone information, caller identification, voice mail and video conferencing services, to be set by service providers.

There is uncertainty with respect to how the Ministry of Information Industry would make a determination regarding effective competition as it has not publicly disclosed the criteria it uses for determining whether a certain type of service should be subject to market based tariffs. Under the Telecommunications Regulations, cost should be the primary basis for tariff setting, but the tariff level should also take into account social and economic development, the development of the telecommunications industry and consumers' ability to afford the services. The Ministry of Information Industry has not provided a timetable for tariff deregulation or indicated that service providers will eventually be permitted to freely set all tariffs.

Over the past few years, the Chinese government has adjusted the tariffs for telecommunications services, including the elimination of connection fees in July 2001. See [B. Business Overview Wireline Telephone Services](#) included elsewhere under this item. In general, we expect these adjustments to stimulate the overall usage of our telecommunications services. We also expect that increased flexibility in setting certain tariffs will allow us to better respond to changes in market demand and competitive conditions. For a discussion on the impact of these adjustments on our financial condition and results of operations, see [Item 5. Operating and Financial Review and Prospects](#).

The Chinese government retains the ultimate authority to adopt changes to tariffs. However, the Telecommunications Regulations require the government to hold public hearings before setting or changing fixed or guidance tariff rates, which should be attended by, among others, telecommunications operators and consumers. See [Item 3. Key Information D. Risk Factors Risks Relating to the Telecommunications Industry in China](#). Our revenues may be adversely affected by reductions in tariffs mandated by the Chinese government.





**Table of Contents*****Interconnection***

Under the Telecommunications Regulations and the Administrative Rules on Interconnection between the Public Telecommunications Networks promulgated by the Ministry of Information Industry in May 2001, major telecommunications operators in China cannot refuse requests for interconnection and must enter into interconnection agreements upon request by other service providers. Interconnection agreements must be filed with the Ministry of Information Industry. Interconnection agreements may not be terminated unilaterally without prior approval by the Ministry of Information Industry.

The Telecommunications Regulations further provide that the technical standards and settlement methods for network interconnections be formulated by the Ministry of Information Industry. In accordance with these regulations, China Telecom Group has entered into various interconnection agreements with other telecommunications service providers, including China Mobile, China Unicom, China Netcom Group and China Railcom.

In October 2003, the Ministry of Information Industry promulgated a new regulation on interconnection between public telecommunications networks. In addition to formalizing certain existing interconnection rules, the new regulation provides for the interconnection settlement arrangements among mobile operators and provide further detailed implementation mechanisms in relation to revenue sharing and settlement arrangements. This new regulation has no significant impact on wireline operators such as us.

The following table sets forth selected interconnection revenue sharing and settlement arrangements for local calls before and after the regulatory adjustment in 2001<sup>(1)</sup>:

<b>Network from Which</b>	<b>Network at Which</b>	<b>Old Settlement Arrangement</b>	<b>New Settlement Arrangement</b>
<b>Calls Originated</b>	<b>Calls Terminated</b>		
Mobile operator	Wireline local operator	(1) Mobile operator collects the cellular usage charge from its subscribers (2) Mobile operator pays RMB0.05 per minute to wireline operator	(1) Mobile operator collects the cellular usage charge from its subscribers (2) Mobile operator pays RMB0.06 per minute to wireline operator
Wireline local operator	Mobile operator	No revenue sharing or settlement	No revenue sharing or settlement
Wireline local operator A	Wireline local operator B	(1) Operator A collects the usage charge from its subscribers (2) In the case of intra-district calls, operator A and operator B equally share the revenue. In the case of inter-district calls, the operator whose inter-district transmission facility is used in transmitting the call gets 90% of the usage charge and the other operator gets 10%.	

(1) Except for settlement arrangement between mobile operators which became effective in 2003.



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The following table sets forth selected current main interconnection revenue sharing and settlement arrangements for public switched telephone network domestic long distance calls:

<b>Network from Which</b>	<b>Network at Which</b>	<b>Current Main Settlement</b>
<b>Calls Originated</b>	<b>Calls Terminated</b>	<b>Arrangement</b>
Wireline local or mobile operator A	Wireline local or mobile operator B, through the long distance network of operator C	RMB0.06 per minute for operator A, RMB0.06 per minute for operator B, the rest of the long distance tariff for operator C

The following table sets forth selected current main interconnection revenue sharing and settlement arrangements for public switched telephone network international long distance calls, including calls originated from and terminated in Hong Kong, Macau and Taiwan:

<b>Network from Which</b>	<b>Network at Which</b>	<b>Current Main Settlement</b>
<b>Calls Originated</b>	<b>Calls Terminated</b>	<b>Arrangement</b>
Domestic wireline local or mobile operator A	International long distance operator B, through the domestic long distance network of operator C to international gateway	RMB0.06 per minute for operator A, not more than RMB0.54 per minute for operator C, the rest of the international long distance tariff for operator B, where operator A and operator B, or operator B and operator C can be the same operator
International long distance operator A	Domestic wireline local or mobile operator B, through domestic long distance network of operator C and international gateway of operator D	RMB0.06 per minute for operator B, not more than RMB0.54 per minute for operator C, the rest of the international long distance tariff for operator D, where operator B and operator C, or operator C and operator D can be the same operator

The following table sets forth selected current main interconnection revenue sharing and settlement arrangements for VoIP long distance calls:

<b>Network from Which Calls</b>	<b>Network at Which Calls</b>	<b>Current Main Settlement</b>
<b>Originated</b>	<b>Terminated</b>	<b>Arrangement</b>
Wireline or mobile network A	Wireline local or mobile operator B through the VoIP network of operator C	<ol style="list-style-type: none"> <li>(1) Operator C collects the VoIP long distance charges from its subscribers</li> <li>(2) Operator C pays RMB0.06 per minute to operator B on the terminating end</li> <li>(3) No settlement between operator C and operator A on the originating end</li> </ol>

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Effective November 1, 2002, the Ministry of Information Industry has unified the minimum level of the termination rate for international calls, including for this purpose calls from Hong Kong, Macau and Taiwan, terminating in mainland China. Such termination rate is required to be no less than US\$0.17 per minute, but can be higher based upon negotiations between the carriers.

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### ***Technical Standards***

The Ministry of Information Industry sets industry technical standards for telecommunications terminal and interconnection-related equipment used in the public telecommunications networks. A network access license from the Ministry of Information Industry and other relevant regulatory authorities is required for all such equipment. Most of the standards set by the Ministry of Information Industry conform to standards recommended by the International Telecommunications Union and other international telecommunications standards organizations.

### ***Capital Investment***

On July 16, 2004, the State Council promulgated, effective immediately, the Decision on Reform of Investment System, or the Investment Reform Decision, which significantly modified the government approval process for major investment projects in China. The Investment Reform Decision eliminated the government approval requirements for investment projects that do not involve direct government funding unless the investment projects are in the restricted sectors specified in the annually adjusted catalogue released by the State Council. The 2004 catalogue, which was attached as an annex to the Investment Reform Decision, sets forth approval requirements for individual investment projects in restricted sectors. Within the telecommunications sector, some investment projects in certain areas, such as domestic backbone transmission network, require the National Development and Reform Commission's approval.

The Investment Reform Decision grants large enterprises more power of decision-making on investment. Where a large enterprise which has established modern corporate governance invests in any of the projects in the restricted sectors specified in the 2004 catalogue, it may apply for approval on individual project basis, or make medium and long-term development and construction plan, which, if approved by the State Council or the competent governmental authority, no specific approval is required for the projects contemplated in the plan. In this case, the enterprise is only required to go through the registration process and report to the relevant governmental authority, on a timely basis, the construction process of the project.

### ***Telecommunications Resources***

The Ministry of Information Industry is responsible for the administration and allocation of telecommunications resources in China, including radio frequencies and telecommunications network numbers. The use of these resources by telecommunications service providers is subject to the approval of the Ministry of Information Industry or the relevant provincial communications administrations and a usage fee payable to the Chinese government.

On December 31, 2004, the Ministry of Information Industry, the Ministry of Finance and the National Development and Reform Commission promulgated the Interim Measure on Collection of Usage Fees of Telecommunications Network Numbers, or the Interim Measures, effective January 1, 2005. The Interim Measures provide for the standards and collection of usage fees of telecommunications network numbers. In accordance with the Interim Measures, telecommunications services providers, including us, shall pay the usage fees of telecommunications network numbers.

### ***Quality of Service***

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Under the Telecommunications Regulations, the Ministry of Information Industry and the relevant provincial communications administration have the responsibility of supervising and monitoring the quality of services provided by telecommunications service providers in China. Under the Telecommunications Regulations, customers of telecommunications service providers have the right to submit their complaints to the Ministry of Information Industry and the relevant provincial communications administration or other relevant government authorities.

Under the Consumer Protection Law of China, the Consumers Associations can participate in the inspection and examination of goods and services by relevant governmental authorities; and the customers can lodge their complaints with the Consumers Associations, which can investigate the goods or services involved in the complaints, and mediate the complaints.

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### *Universal Services*

Under the Telecommunications Regulations, telecommunications service providers in China are required to fulfill universal service obligations in accordance with relevant regulations to be promulgated by the Chinese government, and the Ministry of Information Industry has been given authority by the Chinese government to delineate the scope of its universal service obligations. The Ministry of Information Industry may also select universal service providers through a tendering process. The Ministry of Information Industry, together with government finance and pricing authorities, is also responsible for formulating administrative rules relating to the establishment of a universal service fund and compensation schemes for universal services.

Under the Telecommunications Regulations, all Chinese telecommunications operators shall provide universal services, but the formal timetable for the establishment of the systems to implement universal services has not been set up. Currently, China's government requires telecommunications operators to provide telephone services in a number of remote villages in China as transitional measures prior to the formalization of a universal service obligation framework. In order to fulfill such obligations under those transitional measures, China Telecom Group will assume the responsibility for investing in and constructing the necessary network facilities in remote villages of some provinces. We operate and maintain such network facilities, while China Telecom Group will compensate us for the related expenses. Once the universal service regulatory framework is finalized, we will perform our duties thereunder accordingly.

### *State-Owned Assets Supervision*

Under the Company Law of the People's Republic of China, Interim Measures for the Supervision and Administration of State-Owned Assets of the Enterprises, and other administrative regulations, the State-owned Assets Supervision and Administration Commission of the State Council, or the SASAC, among others, supervises the preservation of the value of state-owned assets, guides the reform and restructuring of state-owned enterprises, and evaluates the performances of management executives of state-owned enterprises through legal procedures. Our controlling shareholder, China Telecom Group, is a wholly state-owned enterprise and subject to the SASAC's supervision.

## **C. Organization Structure**

See A. History and Development of the Company Our Restructuring and Initial Public Offering included elsewhere under this item.

## **D. Property, Plants and Equipments**

### *Properties*

### *Executive Offices*



Our principal executive offices are located in Beijing and we obtained the right to occupy and use these offices pursuant to an agreement we entered into with China Telecom Group in September 2002 and its supplemental agreements on October 26, 2003 and April 13, 2004, respectively. See Item 7. Major Shareholders and Related Party Transactions B. Related Party Transactions Ongoing Related Party Transactions between Us and China Telecom Group Centralized Services Agreement.

*Properties*

We conduct our businesses on land and premises either owned by ourselves or leased from China Telecom Group and/or its affiliates and third parties. As to our owned properties, although a majority of the land and building titles to these properties have been registered in our name after they were acquired by us as part of our restructuring, certain land and building titles to these properties are still registered in the name of China Telecom Group. China Telecom Group has agreed to indemnify us against any loss or damage incurred by us caused by or arising from any

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challenge of, or interference with, our right to use these properties. As to our leased properties, China Telecom Group has undertaken to us that it will indemnify us against any loss or damage caused by or arising from any challenge to, or interference with, such right. See Item 7. Major Shareholders and Related Party Transactions B. Related Party Transactions Ongoing Related Party Transactions between Our Subsidiaries and Subsidiaries of China Telecom Group Property Leasing Agreements.

**Item 5. Operating and Financial Review and Prospects.**

*You should read the following discussion and analysis in conjunction with our audited financial statements and our selected financial data, in each case, together with the accompanying notes included elsewhere in this annual report. Our audited financial statements have been prepared in accordance with IFRS. IFRS differs in a number of significant respects from US GAAP. Note 33 to our audited financial statements, included elsewhere in this annual report, contains information relating to the nature and effect of significant differences between IFRS and US GAAP as they relate to us and provides a reconciliation to US GAAP of our net income and shareholders' equity. Since China Telecom Group controlled the telecommunications operations and the related assets transferred to us prior to our restructuring and continues to control us after our restructuring, the financial data of the telecommunications operations transferred to us presented in this section and in our audited financial statements included elsewhere in this annual report for periods prior to our incorporation have been combined in a manner similar to a pooling-of-interests. The assets and liabilities of the entities being combined are carried forward at their recorded historical amounts, and the book value of the assets and liabilities and the revenue and expenses of each of these entities for the periods prior to our incorporation are added together to prepare our financial statements. On December 31, 2003, we acquired the entire equity interests in each of Anhui Telecom Company Limited, Fujian Telecom Company Limited, Jiangxi Telecom Company Limited, Guangxi Telecom Company Limited, Chongqing Telecom Company Limited and Sichuan Telecom Company Limited from China Telecom Group. On June 30, 2004, we acquired the entire equity interests in Hubei Telecom Company Limited, Hunan Telecom Company Limited, Hainan Telecom Company Limited, Guizhou Telecom Company Limited, Yunnan Telecom Company Limited, Shaanxi Telecom Company Limited, Gansu Telecom Company Limited, Qinghai Telecom Company Limited, Ningxia Telecom Company Limited and Xinjiang Telecom Company Limited from China Telecom Group. As we and these acquired companies were under the common control of China Telecom Group, our acquisitions of these companies have been accounted for in a manner similar to a pooling-of-interests. Accordingly, the assets and liabilities of the acquired companies have been accounted for at historical amounts and our financial statements for periods prior to the respective acquisitions have been restated to include the financial position and results of operations of the acquired companies on a combined basis. Unless otherwise indicated in this section, our financial data for periods prior to the acquisitions are presented based on those restated amounts. With respect to the acquisition in 2003, the income statement data for the year ended December 31, 2002 include the results of the assets retained by China Telecom Group in relation to the acquisition in 2003. The results of such assets are not reflected in our income statement for periods beginning after December 31, 2002. These assets are not reflected in our balance sheet as of and after December 31, 2002. With respect to the acquisition in 2004, the income statement data for the years ended December 31, 2002 and 2003 include the results of the assets retained by China Telecom Group in relation to our acquisition in 2004. The results of such assets are not reflected in our income statement for periods beginning after December 31, 2003. The balance sheet data as of December 31, 2002 include data related to the assets retained by China Telecom Group in relation to the acquisition in 2004. These assets are not reflected in our balance sheet as of and after December 31, 2003.*

**Overview**

We are the leading provider of wireline telecommunications services in our service regions in China. Our service regions consist of Anhui Province, Chongqing Municipality, Fujian Province, Gansu Province, Guangdong Province, Guangxi Zhuang Autonomous Region, Guizhou Province, Hainan Province, Hubei Province, Hunan Province, Jiangsu Province, Jiangxi Province, Ningxia Hui Autonomous Region, Qinghai Province, Shaanxi Province, Shanghai Municipality, Sichuan Province, Xinjiang Uygur Autonomous Region, Yunnan Province and Zhejiang Province.

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Our operating revenue increased while our operating expenses grew at a rate below our revenue growth rate. The table below sets forth a breakdown of our operating revenue in terms of amount and as a percentage of our total operating revenue for the periods indicated:

	Year Ended December 31,					
	2002		2003		2004	
	Amount	Percentage of Operating Revenue	Amount	Percentage of Operating Revenue	Amount	Percentage of Operating Revenue
(RMB in millions, except percentage data)						
<b>Operating Revenue:</b>						
<b>Wireline telephone services:<sup>(1)</sup></b>						
Local:						
Installation fees	2,305	1.6%	2,643	1.8%	2,865	1.8%
Monthly fees	25,338	18.0%	27,499	18.2%	29,827	18.5%
Local usage fees	44,440	31.5%	45,815	30.2%	47,646	29.5%
Sub-total	72,083	51.1%	75,957	50.2%	80,338	49.8%
Domestic long distance <sup>(2)</sup>	25,726	18.3%	25,460	16.8%	26,231	16.3%
International, Hong Kong, Macau and Taiwan long distance <sup>(2)</sup>	3,878	2.8%	3,943	2.6%	3,788	2.3%
Interconnection <sup>(3)</sup>	7,524	5.3%	8,365	5.5%	10,719	6.6%
Upfront connection fees	10,564	7.5%	9,771	6.4%	8,458	5.3%
Sub-total	119,775	85.0%	123,496	81.5%	129,534	80.3%
<b>Internet and managed data services:</b>						
Internet <sup>(4)</sup>	5,998	4.3%	10,007	6.6%	14,109	8.8%
Managed data <sup>(5)</sup>	3,147	2.2%	3,210	2.1%	3,015	1.9%
Sub-total	9,145	6.5%	13,217	8.7%	17,124	10.7%
<b>Leased line services</b>	<b>5,520</b>	<b>3.9%</b>	<b>5,103</b>	<b>3.4%</b>	<b>4,154</b>	<b>2.6%</b>
<b>Other services<sup>(6)</sup></b>	<b>6,466</b>	<b>4.6%</b>	<b>9,737</b>	<b>6.4%</b>	<b>10,400</b>	<b>6.4%</b>
<b>Total operating revenue</b>	<b>140,906</b>	<b>100.0%</b>	<b>151,553</b>	<b>100.0%</b>	<b>161,212</b>	<b>100.0%</b>

- (1) Includes revenue from our registered subscribers, public telephones and prepaid calling card services. Revenue from prepaid calling card services is recognized as the services are provided to our customers.
- (2) Includes revenue from our VoIP long distance services.
- (3) Includes charges to domestic and foreign telecommunications operators for delivery of calls connecting to our wireline telecommunications networks.
- (4) Includes revenue from dial-up and broadband Internet access services.
- (5) Includes revenue from DDN, frame relay and ATM services.
- (6) Includes revenue from value-added telecommunications services, sale, repairs and maintenance of certain customer-end equipment and lease of telecommunications network facilities.

Our total operating revenue is mainly affected by the number of our subscribers, the level of usage of our services and the levels and structure of our tariffs. Our total operating revenue increased from RMB151,553 million in 2003 to RMB 161,212 million, or approximately 6.4%, in 2004 primarily due to the growth in our local telephone service revenue, Internet services revenue and interconnection revenue. Revenue from our long distance services increased at a moderate rate, while revenue from our managed data and leased line services decreased.

Revenue from our local telephone services increased by approximately 5.8% from RMB75,957 million in 2003 to RMB80,338 million in 2004, primarily as a result of the continued growth in our subscriber and usage volume. The number of our telephone access lines in service increased from 161.0 million as of December 31, 2003 to 186.7 million as of December 31, 2004. Although wireline usage sustained favorable growth, we expect the growth to slow down due to further expansion and price fluctuation of mobile service.

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Revenue from our domestic long distance services increased by approximately 3.0% in 2004 primarily due to the increase of total usage while revenue from international, Hong Kong, Macau and Taiwan long distance services decreased by approximately 3.9% in 2004 as a result of the decrease in prices. Revenue from interconnection services increased by approximately 28.1% in 2004 primarily attributed to an increase in interconnection volume as a result of the expansion of the domestic services subscribers.

Revenue from Internet services increased approximately 41.0% from 2003 to 2004 due primarily to the broadband subscriber growth. Revenue from our Internet services accounted for approximately 8.8% of our total operating revenue in 2004. We expect further development in our broadband services continues to drive the growth of our revenue. Revenue from our managed data and leased line services decreased by 6.1% and 18.6%, respectively, in 2004, primarily due to decreases in prices as a result of the intensifying market competition. Revenue from our other business increased approximately 6.8% from 2003 to 2004 primarily due to the increase in revenue from value-added services, including caller display service and telephone message service.

The following table sets forth a breakdown of our operating expenses in terms of amount and as a percentage of our total operating revenue for the periods indicated:

	Year Ended December 31,					
	2002		2003		2004	
	Amount	Percentage of Operating Revenue	Amount	Percentage of Operating Revenue	Amount	Percentage of Operating Revenue
(RMB in millions, except percentage data)						
<b>Operating Expenses:</b>						
Depreciation and amortization	45,810	32.5%	46,597	30.7%	47,170	29.3%
Network operations and support <sup>(1)</sup>	34,403	24.4%	31,338	20.7%	27,611	17.1%
Selling, general and administrative <sup>(1)</sup>	13,503	9.6%	16,778	11.1%	19,229	11.9%
Personnel	18,894	13.4%	20,812	13.7%	23,233	14.4%
Interconnection charges and other expenses	3,188	2.3%	3,176	2.1%	4,139	2.6%
<b>Total operating expenses</b>	<b>115,798</b>	<b>82.2%</b>	<b>118,701</b>	<b>78.3%</b>	<b>121,382</b>	<b>75.3%</b>

(1) Excluding related personnel expenses.

Our total operating expenses increased by approximately 2.3% from RMB118,701million in 2003 to RMB121,382 million in 2004. Our network operations and support expenses decreased by approximately 11.9% in 2004. Our depreciation and amortization expenses slightly increased approximately by 1.2% in 2004. Our selling, general and administrative expenses, our personnel expenses and our interconnection and other operating expenses increased approximately 14.6%, 11.6% and 30.3% respectively. Our selling expenses increased due to the reinforcement of our marketing to cope with increasingly intensified market competition while our general and administrative expenses decreased primarily due to our strict expenditure control. Our personnel expenses increased due to the further reform of performance-linked remuneration scheme to attract and retain talented employees and motivate employees. Our interconnection charges and other expenses increased due to the increase of inter-network traffic. As a percentage of total operating revenue, total operating expenses decreased to approximately 75.3% in 2004 from 78.3% in 2003.

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The following table sets forth our total operating revenue, operating expenses, operating income and net income in terms of amount and as a percentage of our total operating revenue, and cash flows from operating activities for the periods indicated:

	Year Ended December 31,					
	2002		2003		2004	
	Amount	Percentage of Operating Revenue	Amount	Percentage of Operating Revenue	Amount	Percentage of Operating Revenue
	(RMB in millions, except percentage data)					
Operating revenue	140,906	100.0%	151,553	100.0%	161,212	100.0%
Operating expenses	115,798	82.2%	118,701	78.3%	121,382	75.3%
Operating income	25,108	17.8%	32,852	21.7%	39,830	24.7%
Net income	8,219	5.8%	13,882	9.2%	28,023	17.4%
Cash flows from operating activities	62,357		58,392		66,078	

Our operating income increased by approximately 21.2%, from RMB32,852 million in 2003 to RMB39,830 million in 2004, primarily as a result of the increase in our operating revenue and a lower corresponding rate of increase in our operating expenses.

**Critical Accounting Policies**

Our discussion and analysis of our financial condition and results of operations contained elsewhere in this annual report are based on our audited financial statements which have been prepared in accordance with IFRS. Our reported financial condition and results of operations are sensitive to accounting methods, assumptions and estimates that underlie the preparation of our financial statements. We base our assumptions and estimates on historical experience and on various other assumptions that we believe to be reasonable and which form the basis for making judgments about matters that are not readily apparent from other sources. On an on-going basis, our management evaluates its estimates. Actual results may differ from those estimates as facts, circumstances and conditions change.

The selection of critical accounting policies, the judgments and other uncertainties affecting application of those policies and the sensitivity of reported results to changes in conditions and assumptions are factors to be considered when reviewing our financial statements. Our principal accounting policies are set forth in detail in Note 2 to our audited financial statements included elsewhere in this annual report. We believe the following critical accounting policies involve the most significant judgments and estimates used in the preparation of our financial statements.

**Accounting for Long-lived Assets**

**Depreciation.** Property, plant and equipment are depreciated on a straight-line basis over the estimated useful lives of the assets, after taking into account their estimated residual value. The following estimated useful lives are used for depreciation purpose. These estimated useful lives are based on our historical experience with similar assets and take into account anticipated technological changes.

	<b>Depreciable lives primarily range from</b>
Buildings and improvements	8 - 30 years
Telecommunications network plant, transmission and switching equipment	6 - 10 years
Furniture, fixture, motor vehicles and other equipment	4 - 10 years

We review the estimated useful lives of the assets regularly in order to determine the amount of depreciation expense to be recorded during any reporting period. The depreciation expense for future periods is adjusted if there are significant changes from previous estimates. There have been no significant changes to the estimated useful lives and residual value during each of the three years ended December 31, 2004.

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*Impairment.* The carrying amounts of long-lived assets, including property, plant and equipment, are reviewed periodically in order to assess whether the recoverable amounts have declined below the carrying amounts. These assets are tested for impairment whenever events or changes in circumstances indicate that their recorded carrying amounts may not be recoverable. When such a decline has occurred, the carrying amount is reduced to the recoverable amount. The amount of impairment loss is the difference between the carrying amounts of the assets and their recoverable amounts. The recoverable amount is the greater of the net selling price and the value in use. In determining the value in use, expected future cash flows generated by the assets are discounted to their present value, which requires significant judgment in terms of projection of cash flows for future years and the assumption on the pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. Under US GAAP, the company is required to record an impairment to reflect the fair value of long-lived assets, and the fair value of the assets under US GAAP is determined using the discounted cash flow method similar to that used for determining the assets' value in use under IFRS. For the year ended December 31, 2004, RMB88 million impairment losses were recognized in our audited income statement. As a result, the carrying value of certain equipment for outdated telecommunications services have been fully written off. No impairment losses were recognized for the years ended December 31, 2002 and 2003.

*Revaluation.* As required by the relevant PRC rules and regulations, our property, plant and equipment were revalued as of December 31, 2001, and the property, plant and equipment of the companies that we acquired in 2003 and 2004 were revalued as of December 31, 2002 and December 31, 2003, respectively. These revaluations were carried out for each asset class by independent valuers on a depreciated replacement cost basis. Subsequent to the revaluation, property, plant and equipment are carried at the revalued amount, being the fair value as of the date of the revaluation, less subsequent accumulated depreciation and impairment losses. Revaluations are performed with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date. We revalued our property, plant and equipment on a depreciated replacement cost basis in accordance with our IFRS accounting policies as of December 31, 2004. The results of subsequent revaluations may have an impact on our future results to the extent the fair values of our property, plant and equipment change significantly.

***Revenue Recognition for Upfront Connection and Installation Fees***

We defer the recognition of upfront customer connection and installation fees and amortize them over the expected customer relationship period of ten years. The related direct incremental customer acquisition costs (including direct costs of installation) are also deferred and amortized over the same expected customer relationship period. We estimate the expected customer relationship period based on our historical customer retention experience and factoring in the expected level of future competition, the risk of technological or functional obsolescence to our services, technological innovation, and the expected changes in the regulatory and social environment. If our estimate of the expected customer relationship period changes as a result of increased competition, changes in telecommunications technology or other factors, the amount and timing of recognition of our deferred revenue would change for future periods. There have been no significant changes to the estimated customer relationship period for each of the three years ended December 31, 2004.

***Provision for Doubtful Debts***

We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make the required payments. We base our estimates on the aging of our accounts receivable balance, customer credit-worthiness, and historical write-off experience. If the financial condition of our customers were to deteriorate, actual write-offs might be higher than expected.

Amounts due from the provision of wireline telecommunications services to residential and business customers are due within 30 days from the date of billing. Customers who have accounts overdue by more than 90 days will have their services disconnected.





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The following table summarizes the changes in the allowance for doubtful accounts for each of the years in the three-year period ended December 31, 2004:

	<u>Year ended December 31,</u>		
	<u>2002</u>	<u>2003</u>	<u>2004</u>
	(RMB in millions)		
At beginning of year	1,853	1,859	1,818
Provision for doubtful accounts	1,004	1,037	1,121
Accounts receivable written off	(998)	(1,078)	(1,257)
At end of year	<u>1,859</u>	<u>1,818</u>	<u>1,682</u>

***Recently pronounced International Financial Reporting Standards***

The International Accounting Standards Board ( IASB ) has issued a number of new and revised International Financial Reporting Standards and International Accounting Standards (collectively new IFRSs ) which are applicable to the Company for accounting periods beginning on or after January 1, 2005.

The Company has not early adopted these new IFRSs in the financial statements for the year ended December 31, 2004. The Company has completed a preliminary assessment of the impact of these new IFRSs to the extent that they are applicable to the Company. A brief summary of the key features of these new IFRSs and the Company's preliminary assessment result is as follows:

***IFRS 2***

In February 2004, the IASB issued IFRS 2, *Share-based Payment* . IFRS 2 addresses the accounting for share-based payment transactions in financial statements and requires an entity to measure the employee service received and the liability incurred at the fair value of the instrument at the grant date, and re-measure the fair value of the liability at each balance sheet date until the final settlement of the liability. Currently, the Company does not expect the application of IFRS 2 will have a material impact on its consolidated financial position or consolidated results of operations.

***IFRS 3***

In March 2004, the IASB issued IFRS 3, *Business Combinations* and replaced IAS 22 *Business Combinations* and related Interpretations. IFRS 3 requires all business combinations within its scope to be accounted for using the purchase method. IFRS 3 also requires positive goodwill to be tested for impairment annually and stated at cost less accumulated impairment losses, and negative goodwill be recognised immediately in the income statement on acquisition. The Company cannot determine the potential effects that application of IFRS 3 will have on its consolidated

financial statements.

*IFRS 5*

In March 2004, the IASB issued IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*. IFRS 5 requires that assets or disposal groups that are classified as held for sale are carried at the lower of carrying amount and fair value less costs to sell. IFRS 5 replaced IAS 35, *Discontinued Operations* and classifies an operation as discontinued at the date the operation meets the criteria to be classified as held for sale or when the entity has disposed of the operation. The Company cannot determine the potential effects that application of IFRS 5 will have on its consolidated financial statements.

*IAS 1*

In December 2003, the IASB issued IAS 1 (Revised 2003), *Presentation of Financial Statements* and replaced IAS 1 (Revised 1997). IAS 1 (Revised 2003) requires disclosure of an entity's judgments and assumptions on application of its accounting policies. Additionally, IAS 1 (Revised 2003) provides further guidance on classification of assets and liabilities. Currently, the Company does not expect the application of IAS 1 (Revised 2003) will have a material impact on its consolidated financial position or consolidated results of operations.

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*IAS 2*

In December 2003, the IASB issued IAS 2 (Revised 2003), *Inventories* and replaced IAS 2 (Revised 1993) and a related Interpretation. IAS 2 (Revised 2003) eliminates the allowed alternative to measure inventories using the last-in, first-out ( LIFO ) method. Additionally, IAS 2 (Revised 2003) requires finance costs of inventories purchased with deferred settlement terms to be accounted for separately over the period of financing. Currently, the Company does not expect the application of IAS 2 (Revised 2003) will have a material impact on its consolidated financial position or consolidated results of operations.

*IAS 8*

In December 2003, the IASB issued IAS 8 (Revised 2003), *Accounting Policies, Changes in Accounting Estimates and Errors*, and replaced IAS 8. IAS 8 (Revised 2003) requires retrospective application of voluntary changes in accounting policies and retrospective restatement to correct prior period errors and eliminates the allowed alternative to include such adjustment in the current period income statement. IAS 8 (Revised 2003) requires, rather than encourage, disclosure of an impending change in accounting policy when an entity has yet to implement a new Standard or Interpretation that has been issued but not yet come into effect. Currently, the Company does not expect the application of IAS 8 (Revised 2003) will have a material impact on its consolidated financial position or consolidated results of operations.

*IAS 16*

In December 2003, the IASB issued IAS 16 (Revised 2003), *Property, Plant and Equipment* and replaced IAS 16 (Revised 1997) and related Interpretations. IAS 16 (Revised 2003) requires an entity to determine cost, useful life and depreciation charge separately for each significant part of an item of property, plant and equipment, and derecognize the carrying amount of a part of an item of property, plant and equipment if that part has been replaced. IAS 16 (Revised 2003) also requires an entity to include the costs of dismantlement, removal or restoration, the obligation for which an entity incurs as a consequence of installing the item in the cost of property, plant and equipment. Currently, the Company does not expect the application of IAS 16 (Revised 2003) will have a material impact on its consolidated financial position or consolidated results of operations.

*IAS 17*

In December 2003, the IASB issued IAS 17 (Revised 2003), *Leases* and replaced IAS 17 (Revised 1997). IAS 17 (Revised 2003) requires a lump sum lease of land and building to be split into a lease of land and a lease of building, in proportion to the relative fair values of the leasehold interests in the land and building elements of the lease, and account for the lease of land and lease of building separately by applying the classification criteria in the standard. Currently, the Company does not expect the application of IAS 17 (Revised 2003) will have a material impact on its consolidated financial position or consolidated results of operations.

*IAS 21*

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In December 2003, the IASB issued IAS 21 (Revised 2003), *The Effects of Changes in Foreign Exchange Rates*, which replaced IAS 21 (revised 1993) and related Interpretation. IAS 21 (Revised 2003) requires each individual entity included in a reporting entity to determine its functional currency and measure its results and financial position in that currency and stipulates that an entity previously classified as an integral foreign operation will have the same functional currency as the reporting entity. Furthermore, IAS 21 (Revised 2003) disallows capitalizing exchange differences resulting from a severe devaluation or depreciation of a currency against which there is no means of hedging, and requires such differences be recognized in the income statement. Currently, the Company does not expect the application of IAS 21 (Revised 2003) will have a material impact on its consolidated financial position or consolidated results of operations.

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### *IAS 24*

In December 2003, the IASB issued IAS 24 (Revised 2003), *Related Party Disclosures*, which replaced IAS 24 (reformatted 1994). IAS 24 (Revised 2003) expands the scope of related parties and removes the exemption of profit-oriented state controlled entities from disclosing transactions with other state-controlled entities. IAS 24 (Revised 2003) also requires additional disclosures, including the compensation of key management personnel. Currently, the Company does not expect the application of IAS 24 (Revised 2003) will have a material impact on its consolidated financial position or consolidated results of operations.

### *IAS 27*

In December 2003, the IASB issued IAS 27 (Revised 2003), *Consolidated and Separate Financial Statements*, which replaced IAS 27 (Revised 2000) and a related Interpretation. IAS 27 (Revised 2003) modifies the conditions for exempting a parent from preparing consolidated financial statements and the conditions for excluding subsidiaries from consolidation. IAS 27 (Revised 2003) also requires minority interests to be presented within equity, separately from the parent shareholders' equity. In addition, IAS 27 (Revised 2003) prohibits the use of equity method of accounting for investments in subsidiaries, jointly controlled entities and associates in a parent's separate financial statements. Currently, the Company does not expect the application of IAS 27 (Revised 2003) will have a material impact on its consolidated financial position or consolidated results of operations.

### *IAS 28*

In December 2003, the IASB issued IAS 28 (Revised 2003), *Investments in Associates*, which replaced IAS 28 (Revised 2000) and related Interpretations. IAS 28 (Revised 2003) clarifies its scope and the circumstances for which investments in associates must be accounted for using the equity method. Currently, the Company does not expect the application of IAS 28 (Revised 2003) will have a material impact on its consolidated financial position or consolidated results of operations.

### *IAS 32*

In December 2003, the IASB issued IAS 32 (Revised 2003), *Financial Instrument: Disclosure and Presentation*, which replaced IAS 32 (Revised 2000) and related Interpretations. IAS 32 (Revised 2003) clarifies the principle for classifying a financial instrument, and introduces additional disclosures. Currently, the Company does not expect the application of IAS 32 (Revised 2003) will have a material impact on its consolidated financial position or consolidated results of operations.

### *IAS 33*

In December 2003, the IASB issued IAS 33 (Revised 2003), *Earnings Per Share*, which replaced IAS 33 (Revised 1997) and a related Interpretation. IAS 33 (Revised 2003) provides guidance and illustrative examples on selected complex matters in respect of the calculation of earnings per share. Currently, the Company does not expect the application of IAS 33 (Revised 2003) will have a material impact on its

consolidated financial position or consolidated results of operations.

*IAS 36*

In March 2004, the IASB issued IAS 36 (Revised 2004), *Impairment of Assets*, which replaced IAS 36 (Revised 1998). IAS 36 (Revised 2004) requires that the recoverable amount of any intangible asset with an indefinite useful life or not yet available for use, and goodwill acquired in a business combination, be measured annually, rather than only when there is an indication that the asset may be impaired as required by IAS 36 (Revised 1998). In addition, IAS 36 (Revised 2004) clarifies the elements that should be reflected in the calculation of an asset's value in use. Currently, the Company does not expect the application of IAS 36 (Revised 2004) will have a material impact on its consolidated financial position or consolidated results of operations.

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### *IAS 38*

In March 2004, the IASB issued IAS 38 (Revised 2004), *Intangible Assets*, which replaced IAS 38 (Revised 1998). IAS 38 (Revised 2004) revises the definition of an intangible asset and provides further guidance on recognition of an intangible asset. IAS 38 (Revised 2004) also requires an entity to determine whether the useful life of an intangible asset is definite or indefinite and removes the rebuttable presumption that the useful life of an intangible asset does not exceed 20 years. Currently, the Company does not expect the application of IAS 38 (Revised 2004) will have a material impact on its consolidated financial position or consolidated results of operations.

### *IAS 39*

In December 2003 and March 2004, the IASB issued IAS 39 (Revised 2003), *Financial Instruments: Recognition and Measurement* and Amendments to IAS 39 (March 2004), *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk*, respectively. The revised IAS 39 amends its scope and clarifies the conditions for de-recognition of a financial asset. Additionally, the revised IAS 39 provides further guidance on determining fair value using valuation techniques and evaluating impairment of financial assets. Currently, the Company does not expect the application of the revised IAS 39 will have a material impact on its consolidated financial position or consolidated results of operations.

## **A. Operating Results**

### ***Year Ended December 31, 2004 Compared to Year Ended December 31, 2003***

#### ***Operating Revenue***

Our operating revenue grew by RMB9,659 million, or approximately 6.4%, from RMB151,553 million in 2003 to RMB161,212 million in 2004. This increase primarily reflected increases in revenue from local telephone services, Internet services revenue and interconnection revenue.

*Local Telephone Services.* Revenue from our local wireline telephone services increased by approximately 5.8%, from RMB75,957 million in 2003 to RMB80,338 million in 2004. This increase was primarily due to continued growth in our subscriber base and local usage volume. Revenue from local telephone services accounted for approximately 49.8% of our total operating revenue in 2004, compared to approximately 50.2% in 2003. As of December 31, 2004, the total number of our local telephone access lines increased by 25.7 million, or approximately 15.9%, from 161.0 million in 2003 to 186.7 million in 2004.

*Installation Fees.* Installation fees received from customers are deferred and amortized over the expected customer relationship period of 10 years. Revenue from the amortized amount of upfront installation fees increased by approximately 8.4%, from RMB2,643 million in 2003 to RMB2,865 million in 2004. The increase was primarily due to continuous increase in access lines in service.



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*Monthly Fees.* Monthly fee revenue increased by approximately 8.5%, from RMB27,499 million in 2003 to RMB29,827 million in 2004, primarily due to the increase of our local telephone subscribers.

*Local Usage Fees.* Our local usage includes local voice usage and dial-up Internet usage. Revenue from local usage fees increased by approximately 4.0%, from RMB45,815 million in 2003 to RMB47,646 million in 2004. While usage of dial-up Internet services, with lower fees than those for voice services, declined approximately 46.7% from 2003, which we believe is a result of customer migration to our broadband services, voice usage grew by approximately 11.6% to 429,150 million pulses in 2004 from 384,496 million pulses in 2003.

*Domestic Long Distance Services.* Domestic long distance revenue increased by approximately 3.0%, from RMB25,460 million in 2003 to RMB26,231 million in 2004. While the price for long distance services decreased, the total usage of our domestic long distance services increased from 67,312 million minutes in 2003 by

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approximately 21.8% to 81,960 million minutes in 2004 as we adopted a more effective pricing strategy and accelerated the development of public telephone supermarkets. Such increase of usage has offset the price decrease in our domestic long distance services.

*International, Hong Kong, Macau and Taiwan Long Distance Services.* Revenue from international, Hong Kong, Macau and Taiwan long distance services decreased by approximately 3.9%, from RMB3,943 million in 2003 to RMB3,788 million in 2004. Total usage of international, Hong Kong, Macau and Taiwan long distance services (including calls originated from wireline and mobile subscribers) was similar to that in 2003. The decrease in revenue was attributable to the decrease in prices.

*Interconnection Services.* Revenue from interconnection fees increased by approximately 28.1%, from RMB8,365 million in 2003 to RMB10,719 million in 2004. This increase was primarily due to an increase in interconnection volume as a result of the expansion in the domestic telecommunications services subscribers. Our net interconnection income (interconnection revenue deducted by interconnection expenses) was RMB6,624 million, representing a 25.9% increase compared to RMB5,261 million in 2003.

*Upfront Connection Fees.* Upfront connection fees represent the amortized amount of the upfront fees received from the initial activation of our wireline services. These upfront fees are deferred and amortized over 10 years. Effective on July 1, 2001, we ceased charging upfront connection fees to new subscribers. Consequently, the amortized amount continued to decrease by approximately 13.4%, from RMB9,771 million in 2003 to RMB8,458 million in 2004.

*Internet Services.* Internet access services revenue increased by approximately 41.0%, from RMB10,007 million in 2003 to RMB14,109 million in 2004. Revenue from our Internet services contributed 8.8% to our total operating revenue in 2004, as compared to 6.6% in 2003. The increase of Internet access services revenue was primarily due to the rapid development of broadband services. The number of our broadband subscribers increased from 7.2 million as of December 31, 2003 to 13.8 million as of December 31, 2004. We believe that revenue from our broadband Internet services will remain a major driver for our revenue growth.

*Managed Data Services.* Revenue from managed data services decreased by approximately 6.1%, from RMB3,210 million in 2003 to RMB3,015 million in 2004. The decrease was primarily due to the decreases in prices, which has offset the increase of our leased bandwidth of managed data services. The total leased bandwidth of our DDN services was approximately 493,300x 64Kbps as of December 31, 2004, representing an increase of approximately 4.7% from that as of December 31, 2003. The total leased bandwidth of our ATM services was approximately 23,800x 2Mbps as of December 31, 2004, representing an increase of approximately 25.3% from that as of December 31, 2003, and the total leased bandwidth of our frame relay services was approximately 156,300x 128Kbps as of December 31, 2004, representing an increase of approximately 77.0% from that as of December 31, 2003.

*Leased Line Services.* Revenue from leased line services decreased by approximately 18.6%, from RMB5,103 million in 2003 to RMB4,154 million in 2004. The decrease in revenue was mainly due to the price decrease as a result of the intensifying market competition. As of December 31, 2004, we leased out a total of approximately 169,500x 2Mbps equivalent digital circuits, an increase of approximately 3.9% from 2003.

*Other Services.* Revenue from other services increased by approximately 6.8%, from RMB9,737 million in 2003 to RMB10,400 million in 2004, primarily due to the increase in revenue from value-added services, including caller display services and telephone message service. Revenue derived from these services accounted for approximately 6.4% of our total operating revenue in 2004, as compared to approximately 6.4% in 2003.

*Operating Expenses*

Total operating expenses increased by approximately 2.3%, from RMB118,701 million in 2003 to RMB 121,382 million in 2004, which is lower than the growth rate of our revenue in 2004. Our network operations and support expenses decreased and our depreciation and amortization expenses slightly increased in 2004. Our selling, general and administrative expenses, our personnel expenses and our interconnection and other operating expenses also increased in 2004.

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*Depreciation and Amortization.* Our depreciation and amortization expenses increased by approximately 1.2%, from RMB46,597 million in 2003 to RMB47,170 million in 2004, mainly due to increase in property, plant and equipment. The depreciation and amortization expenses as a percentage of our operating revenue decreased from approximately 30.7% in 2003 to approximately 29.3% in 2004.

*Network Operations and Support.* Excluding personnel related costs of RMB15,459 million in 2004 and RMB12,780 million in 2003, our network operations and support expenses decreased by approximately 11.9%, from RMB31,338 million in 2003 to RMB27,611 million in 2004. This decrease was mainly due to a decrease in repairs and maintenance expenses as a result of our centralized management of network maintenance and resources allocation.

*Selling, General and Administrative.* Excluding personnel related costs of RMB7,774 million in 2004 and RMB8,032 million in 2003, our selling, general and administrative expenses increased to RMB19,229 million in 2004 from RMB16,778 million in 2003. Selling and marketing expenses increased by approximately 34.9% from RMB9,648 million in 2003 to RMB13,019 million in 2004 due to the reinforcement of our marketing strength to cope with increasingly intensified market competition. General and administrative expenses decreased by approximately 12.9%, from RMB7,130 million in 2003 to RMB6,210 million in 2004 due to our strict expenditure control.

*Personnel Expenses.* Personnel expenses increased by approximately 11.6%, from RMB20,812 million in 2003 to RMB23,233 million in 2004. This increase was primarily due to the further reform of performance-linked remuneration scheme to attract and retain talented employees and motivate employees.

*Interconnection Charges and Other Expenses.* Interconnection and other expenses increased by 30.3%, from RMB3,176 million in 2003 to RMB4,139 million in 2004, due to the increase in inter-network traffic.

## ***Net Finance Costs***

Our gross interest expense in 2004 increased to RMB6,834 million from RMB4,948 million in 2003 and our net interest expense also increased from RMB3,340 million in 2003 to RMB5,367 million in 2004. The increases are mainly due to the interest expenses incurred from the deferred payments totaling RMB50,150 million, which are part of the purchase considerations of our 2003 and 2004 acquisitions. We had a net foreign exchange loss of RMB204 million in 2004, compared to a net foreign exchange loss of RMB597 million in 2003.

## ***Income Tax***

Our statutory income tax rate is 33%. In 2004, our income tax expense was RMB5,187 million, representing an effective tax rate of 15.6%. The difference between the statutory tax rate and our effective tax rate was primarily due to the exclusion of the upfront connection fees from taxable revenue, and the preferential income tax rate of 15% applied to some of our branches and subsidiaries located in special economic zones and western part of China. Our effective tax rate being lower than the statutory tax rate was also attributable to the tax credits received by our operating subsidiaries on the purchases of domestic equipment. See Note 24 to our audited financial statements included elsewhere in this annual report for further details in respect of the reconciliation of our effective tax rate to the statutory tax rate of 33%. As the tax credits on purchases of domestic equipment are subject to review and approval of regulatory authorities, we cannot determine with reasonable certainty the amount or timing of such credit to be granted in future periods.

*Net Income*

Our net income reached RMB28,023 million in 2004, with net margin of approximately 17.4%. In connection with the reorganization of the telecommunications business in the ten regions we acquired, we carried out a

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revaluation of the relevant property, plant and equipment in accordance with the relevant regulations in 2003 and a revaluation deficit of RMB14,832 million was resulted. This was one of the reasons for the increase of our net income in 2004 from RMB 13,882 million in 2003.

### ***Inflation***

In recent years, China has not experienced significant inflation, and thus inflation has not had a significant effect on our businesses during the past three years. According to the National Bureau of Statistics of China, China's overall national inflation rate, as represented by the general consumer price index, was approximately 1.2% and 3.9% in 2003 and 2004, respectively. China experienced a slight deflation in 2002 at a rate of 0.8%.

### ***Foreign Currency Fluctuation Impact***

See Item 3. Key Information D. Risk Factors Fluctuation of the Renminbi could materially affect our financial condition and results of operations. and Item 11. Quantitative and Qualitative Disclosures about Market Risk Foreign Exchange Rate Risk. We do not currently hedge our foreign currencies exposure.

### ***Year Ended December 31, 2003 Compared to Year Ended December 31, 2002***

#### ***Operating Revenue***

Our operating revenue grew by RMB10,647 million, or approximately 7.6%, from RMB140,906 million in 2002 to RMB151,553 million in 2003. This increase primarily reflected increases in revenue from local telephone services, Internet services and other services.

#### ***Local Telephone Services.***

Revenue from our local wireline telephone services increased by approximately 5.4%, from RMB72,083 million in 2002 to RMB75,957 million in 2003. This increase was primarily due to subscriber growth and usage increase, attributable to the economic development in our service areas. Revenue from local telephone services accounted for 50.2% of our total operating revenue in 2003, compared to approximately 51.2% in 2002. As of December 31, 2003, the total number of our local telephone access lines increased by 27.9 million, or approximately 21.0%, from 133.1 million in 2002 to 161.0 million in 2003.

*Installation Fees.* Installation fees received from customers are deferred and amortized over the expected customer relationship period of 10 years. Revenue from the amortized amount of upfront installation fees increased by approximately 14.7%, from RMB2,305 million in 2002 to RMB2,643 million in 2003. The increase was primarily due to the continuous increase in the number of our access lines in service in recent years.

*Monthly Fees.* Monthly fee revenue increased by approximately 8.5%, from RMB25,338 million in 2002 to RMB27,499 million in 2003, primarily due to an increase in the average number of our access lines in service.

*Local Usage Fees.* Our local usage includes local voice usage and dial-up Internet usage. Revenue from local usage fees increased by approximately 3.1%, from RMB44,440 million in 2002 to RMB45,815 million in 2003. While usage of dial-up Internet services, with lower fees than those for voice services, declined approximately 28.2% from 2002, which we believe is a result of customer migration to our broadband services, voice usage grew approximately 6.5% to 384,496 million pulses in 2003 from 360,986 million pulses in 2002.

*Domestic Long Distance Services.* Domestic long distance revenue decreased by approximately 1.0%, from RMB25,726 million in 2002 to RMB25,460 million in 2003. While total usage of our domestic long distance services increased, the increased usage reflected mainly increase in usage of our substantially lower-priced VoIP

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services. The total transmission volume for our domestic long distance services increased from 2002 by approximately 13.1%, to 67,312 million minutes in 2003. The decrease in domestic long distance revenue was due to a decrease in actual price caused by the increase in the proportion of VoIP calls.

*International, Hong Kong, Macau and Taiwan Long Distance Services.* Revenue from international, Hong Kong, Macau and Taiwan long distance services increased by approximately 1.7%, from RMB3,878 million in 2002 to RMB3,943 million in 2003. Total usage of international, Hong Kong, Macau and Taiwan long distance services (including calls originated from wireline and mobile subscribers) increased by approximately 8.0%, from 1,546 million minutes in 2002 to 1,670 million minutes in 2003.

*Interconnection Services.* Revenue from interconnection fees increased by approximately 11.2%, from RMB7,524 million in 2002 to RMB 8,365 million in 2003. This increase was primarily due to an increase in interconnection volume. In 2003, our net interconnection income (interconnection revenue deducted by interconnection expenses) was RMB5,261 million, representing an increase of approximately 19.3% compared to RMB4,409 million in 2002.

*Upfront Connection Fees.* Upfront connection fees represent the amortized amount of the upfront fees received from the initial activation of our wireline services. These upfront fees are deferred and amortized over 10 years. Effective on July 1, 2001, we ceased charging upfront connection fees to new subscribers. Consequently, the amortized amount continued to decrease by approximately 7.5%, from RMB10,564 million in 2002 to RMB9,771 million in 2003.

*Internet Services.* Internet access services revenue increased by approximately 66.8%, or RMB4,009 million, from RMB5,998 million in 2002 to RMB10,007 million in 2003. Revenue from our Internet services as a percentage of our total operating revenue also increased from approximately 4.3% in 2002 to 6.6% in 2003. This increase was primarily due to the significant increase in broadband revenue caused by the rapid expansion of our broadband subscriber base. The number of our broadband subscribers increased from 2.4 million as of December 31, 2002 to 7.2 million as of December 31, 2003. We believe that revenue from our broadband Internet services will remain a major driver for our revenue growth.

*Managed Data Services.* Revenue from managed data services increased by approximately 2.0%, from RMB3,147 million in 2002 to RMB3,210 million in 2003. The increase was primarily due to usage growth, which was offset by the effect of pricing packages we implemented in order to increase loyalty of our customers. The total leased bandwidth of our DDN services was 471,200x 64Kbps as of December 31, 2003, representing an increase of approximately 24.6% from that as of December 31, 2002. The total leased bandwidth of our ATM services was 19,000x 2Mbps as of December 31, 2003, representing an increase of approximately 14.5% from that as of December 31, 2002, and the total leased bandwidth of our frame relay services was 88,300x 128Kbps as of December 31, 2003, representing an increase of approximately 83.6% from that as of December 31, 2002. The increase in our leased bandwidth of managed data services was a result of the continuous economic growth and an increase in demand for managed data services in our service regions.

*Leased Line Services.* Revenue from leased line services decreased by approximately 7.6%, from RMB5,520 million in 2002 to RMB5,103 million in 2003. The decrease in revenue was mainly due to a decrease in the prices of our leased line services caused by a change in our customer mix. As of December 31, 2003, we leased out a total of 163,100x2Mbps equivalent digital circuits, decreased slightly by approximately 0.9% from 2002.

*Other Services.* Revenue from other services increased by approximately 50.6%, from RMB6,466 million in 2002 to RMB9,737 million in 2003, primarily due to an increase in revenue from our value-added telecommunications services and revenue from the sale, repair and maintenance of



customer-end equipment.

*Operating Expenses*

Total operating expenses increased by approximately 2.5%, from RMB115,798 million in 2002 to RMB118,701 million in 2003, which is lower than the growth rate of our revenue in 2003. Our network operations and support

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expenses decreased and our depreciation and amortization expenses remained stable in 2003. Our selling, general and administrative expenses and our personnel expenses increased, while our interconnection and other operating expenses remained at similar levels to those in 2002.

*Depreciation and Amortization.* Our depreciation and amortization expenses increased slightly by approximately 1.7%, from RMB45,810 million in 2002 to RMB46,597 million in 2003, mainly due to the increase in property, plant and equipment. The depreciation and amortization expenses as a percentage of our operating revenue decreased from approximately 32.5% in 2002 to approximately 30.7% in 2003.

*Network Operations and Support.* Excluding personnel related costs of RMB12,780 million in 2003 and RMB11,812 million in 2002, our network operations and support expenses decreased by approximately 8.9%, from RMB34,403 million in 2002 to RMB31,338 million in 2003. This decrease was primarily due to a decrease in repair and maintenance expenses by 22.2% to RMB13,489 million in 2003, as we further centralized network maintenance and resource allocation and improved network utilization.

*Selling, General and Administrative.* Excluding personnel related costs of RMB8,032 million in 2003 and RMB7,082 million in 2002, our selling, general and administrative expenses increased to RMB16,778 million in 2003 from RMB13,503 million in 2002. Selling and marketing expenses increased by approximately 67.4% from RMB5,764 million in 2002 to RMB9,648 million in 2003 due to the expansion of our subscriber base. General and administrative expenses decreased by approximately 7.9%, from RMB7,739 million in 2002 to RMB7,130 million in 2003 due to our strict expenditure control.

*Personnel Expenses.* Personnel expenses increased by approximately 10.2%, from RMB18,894 million in 2002 to RMB20,812 million in 2003. This increase was primarily due to an increase in the employee compensation pursuant to our merit-based compensation system in order to retain and motivate competent personnel, and to bring our compensation in line with the prevailing market standards.

*Interconnection Charges and Other Expenses.* Interconnection and other expenses remained stable at RMB3,176 million in 2003, compared to RMB3,188 million in 2002.

## ***Net Finance Costs***

Our cash flows from operating activities enabled us to repay a large amount of bank loans in 2003. By leveraging our high credit ratings from domestic banks in China and our financial risk control, we have swapped some of our long-term loans with short-term loans, which have lower interest rates. This contributed to the decrease in our finance costs. In addition, our gross interest expense in 2003 decreased by RMB546 million from 2002 as a result of the decrease in loan borrowing rate and an increase in the proportion of short term loans, and our net interest expense also decreased from RMB3,826 million in 2002 to RMB3,340 million in 2003. We had a net foreign exchange loss of RMB597 million in 2003, compared to a net foreign exchange loss of RMB493 million in 2002.

## ***Income Tax***

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Our statutory income tax rate is 33%. In 2003, our income tax expense was RMB469 million, representing an effective tax rate of 3.3%. The difference between the statutory tax rate and our effective tax rate was primarily due to the exclusion of the upfront connection fees from taxable revenue, and the preferential income tax rate of 15% applied to some of our branches and subsidiaries located in special economic zones in China. Another reason for our effective tax rate being lower than the statutory tax rate was the tax credits received by our operating subsidiaries on domestic equipment purchases. See Note 24 to our audited financial statements included elsewhere in this annual report for further details in respect of the reconciliation of our effective tax rate to the statutory tax rate of 33%.

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**Table of Contents*****Net Income***

Our net income reached RMB13,882 million in 2003, with net margin of approximately 9.2%, compared to net income of RMB8,219 million with net margin of approximately 5.8% in 2002.

**B. Liquidity and Capital Resources*****Cash Flows and Working Capital***

The following table summarizes our cash flows for the periods indicated:

	<b>Year Ended December 31,</b>		
	<b>2002</b>	<b>2003</b>	<b>2004</b>
	<b>(RMB in millions)</b>		
Cash flows from operating activities	62,357	58,392	66,078
Net cash used in investing activities	(62,578)	(57,094)	(56,353)
Net cash from/(used in) financing activities	7,690	(11,320)	(8,981)
Increase/(decrease) in cash and cash equivalents	7,469	(10,022)	744

Cash and cash equivalents increased by approximately 5.8%, from RMB12,721 million as of December 31, 2003 to RMB13,465 million as of December 31, 2004. Our net cash inflow was RMB744 million in 2004, as opposed to a net cash outflow of RMB10,022 million in 2003, primarily due to, on the one hand, the net proceeds of RMB12,702 million raised from our global offering in 2004, an increase of 7,686 million cash inflows from operating activities and, on the other hand, our cash payment of RMB12,650 million in the same year as part of the acquisition consideration for the telecommunications assets from China Telecom Group.

Our principal source of liquidity is cash generated from operating activities, which reached RMB66,078 million in 2004, an increase of RMB 7,686 million from RMB58,392 million in 2003. This increase was primarily due to the steady development of our business and improvement in operational efficiency. The decrease in cash inflows from operating activities in 2003 as compared to 2002 was mainly due to payment of income tax for both 2002 and 2003 during the year ended December 31, 2003.

Net cash used in investing activities decreased by RMB741 million from 2003 to RMB56,353 million in 2004 due to a further decrease in capital expenditures.

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Net cash used in financing activities was RMB8,981 million in 2004, while net cash used in financing activities was RMB11,320 million in 2003. This change was primarily due to, on the one hand, the net proceeds raised from our global offering in 2004 and, on the other hand, our cash payment in the same year as part of the acquisition consideration for the telecommunications assets from China Telecom Group, the increase of our repayment of loans and distribution of dividends.

Pursuant to the shareholders' approval at the annual general meeting held on May 3, 2004, a final dividend of RMB0.069083 equivalent to HK\$0.065 per share totaling RMB5,224 million in respect of the year ended December 31, 2003 was declared and was paid on May 20, 2004. In respect of the companies we acquired in 2004, the net amount of cash contributed from China Telecom Group to these companies (defined as cash contributions minus cash distributions) was RMB100 million in 2004 and RMB3,265 million in 2003.

Our working capital (defined as current assets minus current liabilities) was a deficit of RMB118,412 million as of December 31, 2004, compared to a deficit of RMB116,042 million as of December 31, 2003. The increase in our working capital deficit was primarily due to the increase of short-term loans at lower interest rates to benefit from our good credit rating, whilst our liquidity risk is still under control.

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We estimate that our current cash and cash equivalents, together with our existing credit facilities from domestic commercial banks, cash flows from operating activities, as well as funds available from short-term and long-term bank borrowings, will be sufficient to satisfy our future working capital requirements and capital expenditures at least through 2005.

**Indebtedness**

Our indebtedness as of the dates indicated was as follows:

	<b>As of December 31,</b>		
	<b>2002</b>	<b>2003</b>	<b>2004</b>
	<b>(RMB in millions)</b>		
Short-term debt	53,196	56,243	65,976
Current portion of long-term debt	13,853	13,957	11,842
Long-term debt, excluding current portion	38,963	68,632	72,366
<b>Total debt</b>	<b>106,012</b>	<b>138,832</b>	<b>150,184</b>

We finance a significant portion of our business operations with short-term loans obtained from commercial banks in China. Short-term loans constituted approximately 26.2% of our total liabilities as of December 31, 2004. We have established and maintained high credit ratings with our principal domestic commercial lenders, which have facilitated our ability to obtain credit on favorable terms to meet our financing requirements. As of December 31, 2004, we had available credit facilities of RMB27,855 million from which we can draw upon. The weighted average interest rate of our short-term debt was 4.4% as of December 31, 2004, representing a decrease of 20 basis points from that as of December 31, 2003.

Our total debt increased by RMB11,352 million from RMB138,832 million as of December 31, 2003 to RMB150,184 million as of December 31, 2004, primarily due to the deferred consideration of RMB15,150 million for our 2004 acquisition of the companies from China Telecom Group. Consequently, our debt-to-asset ratio (total debt divided by total assets) increased from approximately 34.4% in 2003 to approximately 36.4% in 2004, which we believe is a reasonable level.

Excluding the deferred consideration for the acquisitions of RMB50,150 million (2003: RMB35,000 million) our long-term debt (including current portion) decreased from RMB47,589 million as of December 31, 2003 to RMB34,058 million as of December 31, 2004. In contrast, our short-term debt increased from RMB56,243 million as of December 31, 2003, to RMB65,976 million as of December 31, 2004.

Of our total debt as of December 31, 2004, approximately 95.2%, 2.1%, 1.9% and 0.8% were denominated in Renminbi, Japanese yen, U.S. dollars and Euros, respectively. We do not currently hedge our foreign currencies exposure.

Our short-term and long-term debt does not contain any financial covenants which materially restrict our operations. We do not have any financial instruments held for trading purposes, and as of December 31, 2004, we did not hold any derivative instruments which are designated

and qualified as hedging instruments.

**Table of Contents*****Capital Expenditures***

The following table sets forth our historical and planned capital expenditure requirements for the periods indicated. Actual future capital expenditures for the periods after December 31, 2004 may differ from the amounts indicated below.

	Year Ended December 31,					
	2001	2002	2003	2004	2005 (Planned)	2006 (Planned)
	(RMB in millions)					
Total capital expenditures	78,621	59,865	61,587	56,307	55,800	54,800

The total amount of our capital expenditures decreased by approximately 8.6%, from RMB61,587 million in 2003 to RMB56,307 million in 2004. The decrease was primarily due to the continued implementation of our policy to control capital expenditure.

In 2004, we continued to implement our prudent policy on capital expenditures and further optimized the allocation of our capital expenditures. We maintained our leading position in access network and also made efforts to transform existing network into intelligent, broadband and IP based networks. At the same time, we made preparation for the construction of the next generation network.

***Capital Resources***

We expect to fund our capital expenditure needs through a combination of cash generated from our operating activities, short-term and long-term bank loans and other debt and equity financing. We believe we will have sufficient capital resources to satisfy our capital expenditure requirements for the foreseeable future.

**C. Research and Development, Patents and Licenses, etc.**

Our emphasis on research and development has contributed to the development of our advanced network, system, and the rollout of our new applications and services. Our researchers focus on network planning and support, new technology trials, market evaluation, investment-related financial analysis and other key areas. Specific areas of research include fiber optic transmission technology, mobile communications technology, next generation networks, broadband access, data communications, operation and service support systems and development of value-added services.

**D. Trend Information.**



Please refer to our discussion in each section under Item 5. Operating and Financial Review and Prospects A. Operating Results.

**E. Off-Balance Sheet Arrangements**

As of December 31, 2004, we did not have any outstanding derivative financial instruments, off-balance sheet arrangements or guarantees.

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The following table sets forth our contractual obligations as of December 31, 2004: ,

	Payable in					
	Total	2005	2006	2007	2008	Thereafter
(RMB in millions)						
<b>Contractual Obligations:</b>						
Short-term debt	65,976	65,976				
Long-term debt	84,208	11,842	10,022	8,343	552	53,449
Operating lease commitments	1,285	369	187	137	124	468
Capital commitments	4,865	4,865				
<b>Total contractual obligations</b>	<b>156,334</b>	<b>83,052</b>	<b>10,209</b>	<b>8,480</b>	<b>676</b>	<b>53,917</b>

**G. US GAAP Reconciliation**

Our financial statements are prepared in accordance with IFRS, which differs in certain significant respects from US GAAP. The difference, as it applies to our financial statements, primarily relates to the US GAAP requirement that property, plant and equipment be carried at historical cost and depreciation, whereas under IFRS, property, plant and equipment can be carried in the financial statements at the revalued amount and depreciated. See Note 33 to our financial statements included elsewhere in this annual report for further information relating to this difference and a description of recently pronounced U.S. accounting standards.

**Item 6. Directors, Senior Management and Employees.****A. Directors and Senior Management***Directors and Senior Officers*

On October 20, 2004, Mr. Yang Jie and Mr. Sun Kangmin were appointed as executive directors pursuant to the resolutions passed by our shareholders on the extraordinary general meeting. On November 2, 2004, our board of directors accepted the resignation of Mr. Zhou Deqiang as Chief Executive Officer of our Company, and the resignation of Mr. Chang Xiaobing as President and Chief Operating Officer of our Company, and appointed Mr. Wang Xiaochu as Chief Executive Officer of our Company. On December 20, 2004, the extraordinary general meeting of our Company was held and our shareholders passed resolutions regarding the change of our board of directors. Pursuant to the shareholders' resolutions, the resignation of Mr. Zhou Deqiang and Mr. Chang Xiaobing as executive directors, the appointment of Mr. Wang Xiaochu, Mr. Leng Rongquan to serve as executive directors and Mr. Li Jinming to serve as non-executive director of our Company were approved.

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The following table sets forth certain information concerning our directors and executive officers. The business address of each of our directors and executive officers is 31 Jinrong Street, Xicheng District, Beijing, China 100032.

<b>Name</b>	<b>Age</b>	<b>Position</b>
Wang Xiaochu	47	Chairman of the board of directors and Chief Executive Officer
Leng Rongquan	56	Executive director and President and Chief Operating Officer
Wu Andi	50	Executive director, Executive Vice President and Chief Financial Officer
Zhang Jiping	49	Executive director and Executive Vice President
Huang Wenlin	51	Executive director and Executive Vice President

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<b>Name</b>	<b>Age</b>	<b>Position</b>
Li Ping	51	Executive director, Executive Vice President and Joint Company Secretary
Wei Leping	59	Executive director and Executive Vice President
Yang Jie	43	Executive director and Executive Vice President
Sun Kangmin	48	Executive director and Executive Vice President
Cheng Xiyuan	61	Executive director
Feng Xiong	59	Executive director
Li Jinming	53	Non-executive director
Zhang Youcai	64	Independent non-executive director
Shi Wanpeng	68	Independent non-executive director
Vincent Hong Sui Lo	57	Independent non-executive director
Yung Shun Loy, Jacky	42	Assistant Chief Financial Officer and Joint Company Secretary
Wang Qi	50	Controller

*Wang Xiaochu*, 47, is Chairman of the board of directors and Chief Executive Officer of our Company. Mr. Wang held positions such as Director and Deputy Director of the Hangzhou Telecommunications Bureau in Zhejiang Province, Director General of the Tianjin Posts and Telecommunications Administration, Chairman and Chief Executive Officer of China Mobile (Hong Kong) Limited, and Vice President of China Mobile Communications Corporation. Mr. Wang is also President of China Telecommunications Corporation. He was responsible for the development of China Telecom's telephone network management systems and various other information technology projects and as a result, received the Class Three National Science and Technology Advancement Award and the former Ministry of Posts and Telecommunications's Class One Science and Technology Advancement Award. Mr. Wang graduated from Beijing Institute of Posts and Telecommunications in 1980 and has over 24 years of management experience in the telecommunications industry.

*Leng Rongquan*, 56, is executive director, President and Chief Operating Officer of our Company. Mr. Leng is a director level senior engineer. He graduated from the Beijing Institute of Posts and Telecommunications with a Master of Science in engineering. Mr. Leng has held positions such as Chief Engineer of the Beijing Long Distance Telephone Bureau, Deputy Chief Engineer of the Telecommunications Bureau of the Ministry of Posts and Telecommunications, Deputy Director General of the Telecommunications Bureau of the Ministry of Posts and Telecommunications of the PRC, or the MPT, Deputy General Manager of China Telecommunications Corporation, Deputy General Manager of China Network Communications Group Corporation and Vice Chairman of China Netcom Group Corporation (Hong Kong) Limited. Mr. Leng is also Vice President of China Telecommunications Corporation. Mr. Leng has had 29 years of operational management experience in the telecommunications industry in the PRC.

*Wu Andi*, 50, is executive director, Executive Vice President and the Chief Financial Officer of our Company. Ms. Wu is a Senior Accountant. She graduated in 1983 from the Beijing Institute of Economics with a B.A. degree in finance and trading. From 1996 to 1998, Ms. Wu studied in a postgraduate program in business economics management at the Chinese Institute of Social Sciences. Prior to joining China Telecommunications Corporation in May 2000, Ms. Wu served as Director General of the Department of Economic Adjustment and Communication Settlement of the Ministry of Information Industry, and Director General, deputy Director General and Director of the Department of Finance of the MPT. Ms. Wu is also Vice President of China Telecommunications Corporation. Ms. Wu has 23 years of financial experience in the telecommunications industry in China.

*Zhang Jiping*, 49, is Executive Director and Executive Vice President of our Company. Mr. Zhang is a professor level Senior Engineer. He graduated in 1982 from the Beijing Institute of Posts and Telecommunications with a B.S. degree in radio telecommunications engineering. From 1986 to 1988, Mr. Zhang studied in a post-graduate program in applied computer engineering at Northeastern Industrial University. Prior to joining China Telecommunications Corporation in May 2000, Mr. Zhang was a Deputy Director General of the DGT of the MPT, and a Deputy Director General of Liaoning PTA and Director of the Network Management Center of the Liaoning PTA. Mr. Zhang is also Vice President of China Telecommunications Corporation. Mr. Zhang has 23 years of operational and managerial experience in the telecommunications industry in China.



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*Huang Wenlin*, 51, is executive director and Executive Vice President of our Company. Ms. Huang is a Senior Economist. She graduated in 1984 from the Beijing Institute of Posts and Telecommunications with a concentration in engineering management. Prior to joining China Telecommunications Corporation in May 2000, Ms. Huang served as Director of the Domestic Communications Division and Director of the Communications Organization Division of the DGT of the MPT. Ms. Huang is also Vice President of China Telecommunications Corporation. Ms. Huang has 30 years of operational and managerial experience in the telecommunications industry in China.

*Li Ping*, 51, is executive director, Executive Vice President and Joint Company Secretary of our Company. Mr. Li is a Senior Engineer. He graduated in 1976 from the Beijing Institute of Posts and Telecommunications with a major in radio telecommunications and received an MBA degree from the State University of New York at Buffalo in 1989. Prior to joining China Telecommunications Corporation in August 2000, Mr. Li served as Chairman and the President of China Telecom (Hong Kong) International Limited, Vice Chairman and Executive Vice President of China Mobile (Hong Kong) Limited and Deputy Director General of the DGT and the MPT. Mr. Li is also Vice President of China Telecommunications Corporation. Mr. Li has extensive experience in managing public companies and 29 years of operational and managerial experience in the telecommunications industry in China.

*Wei Leping*, 59, is executive director and Executive Vice President of our Company. Mr. Wei is a professor level Senior Engineer. He graduated in 1970 from Tsinghua University with a major in radio engineering and received an M.S. degree in communication and information systems from the Research Institute of Post and Telecommunications. Prior to joining China Telecommunications Corporation in April 2001, Mr. Wei served as Deputy Director of the Telecommunications Research Institute of the Ministry of Information Industry, Deputy Director of the Telecommunications Science Planning and Research Institute of the MPT and Deputy Director and Chief Engineer of the Telecommunications Transmissions Research Center of the MPT. Mr. Wei is also Chief Engineer of China Telecommunications Corporation. Mr. Wei has 27 years of experience in research and development for network technologies in the telecommunications industry in China.

*Yang Jie*, 43, is executive director and Executive Vice President of our Company. Mr. Yang is a senior engineer at professor level. In 1984, Mr. Yang graduated from Beijing University of Posts and Telecommunications with a bachelor's degree in wireless electronic engineering. He then obtained a master degree of telecommunications and information management at the Norwegian School of Management. Mr. Yang previously served as Deputy Director General of Shanxi Administration Bureau of Posts and Telecommunications, General Manager of Shanxi Telecommunications Corporation, Vice President of China Telecom Beijing Research Institute and General Manager of the Northern Telecom Department of China Telecommunications Corporation. He is also Vice President of China Telecommunications Corporation. Mr. Yang has 21 years of experience in handling issues relating to the operation and management of the telecommunications industry in China.

*Sun Kangmin*, 48, is executive director and Executive Vice President of our Company. Mr. Sun is a senior engineer. Mr. Sun previously served as Department Head of the Information Industry Department of Sichuan Province, Director General of Communications Bureau of Sichuan Province as well as Chairman and General Manager of Sichuan Telecom Company Limited. Mr. Sun has 21 years of experience in handling issues relating to the operation and management of the telecommunications industry in China.

*Cheng Xiyuan*, 61, is executive director of our Company and Chairman of the Board of Directors of Shanghai Telecom Company Limited. Mr. Cheng is a professor level Senior Engineer. He graduated from Chongqing Institute of Military Telecommunications and Engineering in 1968 with a major in telecommunications. Prior to joining China Telecom Group, Mr. Cheng served as Director General of Shanghai Long Distance Telephone Bureau, a Deputy Director General, Director General and Chief Engineer of Shanghai PTA and General Manager of China Telecom Group Shanghai Corporation and has 36 years of operational and managerial experience in the telecommunications industry in China.

*Feng Xiong*, 59, is executive director of our Company, Chairman of the board of directors and General Manager of Guangdong Telecom Company Limited. Mr. Feng is a professor level Senior Engineer. He graduated from Tsinghua University in 1970 with a major in electronic engineering. He received a master's degree from Nanjing Institute of Posts and Telecommunications in 1982 with a major in communications and

systems. Prior to

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joining China Telecom Group, Mr. Feng served as Deputy Chief Engineer and Chief Engineer of the Nanjing Municipal Telecommunications Bureau of Jiangsu PTA, and Deputy Chief Engineer, Chief Engineer and a Deputy Director General of Jiangsu PTA. Mr. Feng currently serves as General Manager of China Telecom Group Guangdong Corporation and has 23 years of operational and managerial experience in the telecommunications industry in China.

*Li Jinming*, 53, is non-executive director of our Company. Mr. Li is Chairman of Guangdong Rising Assets Management Co., Ltd., one of the domestic Shareholders of our Company, and director of Shenzhen Zhongjin Lingnan Nonfemet Company Limited. Mr. Li graduated from Guangdong Provincial Broadcast and Television University, and studied in the postgraduate class in the faculty of international economics of Lingnan College, Zhongshan University, majoring in international industry and commerce management. He is currently studying in the EMBA class at Lingnan College, Zhongshan University. Mr. Li has held positions such as Section Chief and Deputy Director General of the Guangdong Provincial Discipline Inspection Commission, and director and Deputy General Manager of Guangdong Rising Assets Management Co., Ltd. Mr. Li has extensive experience in enterprise management.

*Zhang Youcai*, 64, is independent non-executive director of our Company. Mr. Zhang graduated from Nanjing Industrial Chemistry College in 1965 with a major in inorganic chemistry. He was a former Vice Minister of the Ministry of Finance of China and was responsible for the formulation and implementation of government finance policies. Mr. Zhang has contributed to the improvement and reform of the finance system of China over more than a decade. Prior to serving at the Ministry of Finance, Mr. Zhang served as a Deputy Director of the Planning Commission of Nantong City in Jiangsu Province and a Deputy Mayor and Mayor of Nantong. Mr. Zhang has more than 40 years of experience in the regulation of Chinese state-owned enterprises and finance administration.

*Shi Wanpeng*, 68, is independent non-executive director of our Company. He graduated in 1960 from Northern Jiaotong University with a major in Railway Transportation Management. Mr. Shi is a professor level Senior Engineer and served as Deputy Director General and Director General of Department of Transportation and Department of Economy & Technology Cooperation of State Economy & Trade Commission, and Director General of Department of Production Planning of State Development Planning Commission. He had more than 40 years of operational and managerial experience in state-owned enterprise and industry development of PRC.

*Vincent Hong Sui Lo*, 57, is independent non-executive director of our Company. Mr. Lo founded the Shui On Group in 1971 and is the Group's Chairman and Chief Executive. He is also Chairman and Chief Executive Officer of Shui On Land Limited. The Group is engaged in property development, construction, construction materials, and hotel businesses. To further consolidate its prime developments in the Chinese Mainland, the Group established its property flagship Shui On Land Limited in 2004. Mr. Lo is a member of The Tenth National Committee of Chinese People's Political Consultative Conference, Honorary Life President of Business and Professionals Federation of Hong Kong, President of Shanghai-Hong Kong Council for the Promotion and Development of Yangtze, Vice Chairman of All-China Federation of Industry & Commerce, Economic Adviser to the Chongqing Municipal Government, Vice Chairman of Chamber of International Commerce Shanghai, member of Greater Pearl River Delta Business Council, director of Great Eagle Holdings Ltd, non-executive director of Hang Seng Bank Ltd, Court Member of The Hong Kong University of Science and Technology, Adviser to HK-Thailand Business Council, Director of The Real Estate Developers Association of Hong Kong, Adviser to Chinese Society of Macroeconomics and Peking University China Center for Economic Research, and Council Member of China Overseas Friendship Association. He was awarded the Gold Bauhinia Star (GBS) in 1998 and appointed Justice of the Peace in 1999 by the Government of the Hong Kong Special Administrative Region (HKSAR). He was made an Honorary Citizen of Shanghai in 1999. He was named Businessman of the Year by the Hong Kong Business Awards in 2001, and won the Director of the Year Award in the category of Listed Company Executive Directors from The Hong Kong Institute of Directors in 2002.

*Yung Shun Loy, Jacky*, 42, is the assistant Chief Financial Officer, qualified accountant and Joint Company Secretary of our Company. Mr. Yung is a fellow member of the Hong Kong Institute of Certified Public Accountants and a fellow member of the Association of Chartered Certified Accountants of United Kingdom. Mr. Yung is also a Certified Practising Accountant of Australia. Mr. Yung has nearly 20 years of experience in auditing, company secretary and senior financial management of listed companies.





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*Wang Qi*, 50, is the Controller of our Company. Mr. Wang is a senior accountant. He studied at Beijing Institute of Posts and Telecommunications and the Australian National University. Mr. Wang has a B.A. degree in international economics and a master's degree in international management. Prior to joining our Company, Mr. Wang served as a Deputy Director General of Anhui PTA. Mr. Wang also served as a Deputy general Manager of China Telecom Group Anhui Corporation prior to his relocation to the headquarters of China Telecom Group in 2000. Mr. Wang is also managing director of the Finance Department of China Telecommunications Corporation. Mr. Wang has 30 years of managerial and accounting experience in the telecommunications industry in China.

There is no family relationship between any of our directors or executive officers.

***Supervisors***

The following table sets forth certain information concerning our supervisors.

<b>Name</b>	<b>Age</b>	<b>Position</b>
Zhang Xiuqin	58	Chairperson of our supervisory committee
Zhu Lihao	64	Independent supervisor
Xie Songguang	56	Supervisor
Li Jing	39	Supervisor
Wang Huanhui	60	Supervisor

*Zhang Xiuqin*, 58, is the Chairperson of our Supervisory Committee. Ms. Zhang is a Senior Accountant. Prior to joining China Telecom Group, Ms. Zhang served as a Director of the Systems Division of the Financial Department of the MPT, Director of the Department of Economic Adjustment and Communication Settlement of the Ministry of Information Industry, Director of the Communication Settlement Centre of the Ministry of Information Industry and General Manager of the Huaxin Posts and Telecommunication Economic Development Center. Since July 2000, Ms. Zhang has served as Director of the Audit Department of China Telecommunications Corporation. Ms. Zhang has 36 years of operational and managerial experience in the telecommunications industry in China.

*Zhu Lihao*, 64, is an independent supervisor on our Supervisory Committee. Ms. Zhu is a Senior Auditor and is a board member of the Auditors Association. She graduated from Beijing Mining College in 1963 with a major in engineering economics. Ms. Zhu served as a Deputy Director General and Director General of the Department of Industry and Communications of the National Audit Office of China, and the Director General of the Department of Foreign Affairs Auditing of the Audit Bureau. Ms. Zhu has 42 years of experience in management and auditing.

*Xie Songguang*, 56, is a supervisor on our Supervisory Committee. Mr. Xie is a Senior Engineer. He graduated from Nanjing Institute of Posts and Telecommunications in 1985 with a major in communications. Mr. Xie completed an advanced business program in Hangzhou University in 1998. Prior to joining China Telecom Group, Mr. Xie served as a Deputy Director of the Telecommunications Division, and Director of the Operation and Maintenance Division of Zhejiang PTA. Mr. Xie currently serves as a Deputy General Manager of China Telecom Group Zhejiang Corporation and has 30 years of operational and managerial experience in the telecommunications industry in China.

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*Li Jing*, 39, is a supervisor on our Supervisory Committee. Mr. Li is an economist. He graduated from the Central Party School in 1995 with a major in economics and management. Prior to joining China Telecom Group, Mr. Li worked at the Audit Division of the Jiangsu PTA, and the audit department and financial department of Suzhou Municipal Posts and Telecommunications Bureau. Mr. Li currently serves as a Director of the Audit Department of China Telecom Group Jiangsu Corporation and has 20 years of financial and auditing experience in the telecommunications industry in China.

*Wang Huanhui*, 60, has been the supervisor representing employees from April 1 this year. Mr. Wang is a senior economist, and graduated from Beijing Institute of Posts and Telecommunications in 1969. In August 2000, Mr. Wang was appointed as director of Supervisors Board of China Telecommunications Corporations. Mr Wang has more than 30 years of operational and management experience in the telecommunications industry in China.

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### **B. Compensation**

#### **Compensation of Executive Directors and Supervisors**

Our directors and supervisors receive compensation in the form of salaries, housing allowances, other allowances and benefits in kind, including our contribution to the pension plans for our directors and supervisors. For supervisors who are not employed by us, they will receive fees from us. The aggregate amount of compensation we paid to our directors and supervisors as a group for the year ended December 31, 2004 was approximately RMB9.0 million.

#### **Stock Appreciation Rights**

We implemented a plan of stock appreciation rights for members of our senior management in order to provide further incentives to these employees. The plan, effective from November 15, 2002, is designed to link the financial interests of our senior management with our future results of operations and the performance of our H shares. The number of stock appreciation right units granted to a person may also be adjusted in accordance with the result of his or her performance evaluation. Under this plan, stock appreciation rights were granted in units with each unit representing one H share. No shares will be issued under the stock appreciation rights plan.

Our remuneration committee approved the vesting plan for stock appreciation rights in March 2003. Pursuant to the vesting plan, we granted 276 million stock appreciation right units to approximately 451 employees, including members of the board of directors and the supervisory committee (excluding independent directors and independent supervisors), chief executive officer, president, vice presidents, chief financial officer, presidents of provincial subsidiaries and division managers, and heads of our local network operating units structured as strategic business units and basic business units. In March 2004, our board of directors approved a supplemental vesting plan to grant additional stock appreciation rights to senior management members of our provincial subsidiaries in Anhui Province, Fujian Province, Jiangxi Province, Guangxi Zhuang Autonomous Region, Chongqing Municipality and Sichuan Province and newly promoted senior officers of our company who are qualified to receive stock appreciation rights under our stock appreciation rights plan.

Under the plan, all stock appreciation rights will have an exercise period of six years. A recipient of stock appreciation rights may not exercise the rights in the first 18 months after the date of grant. At each of the third, fourth, fifth and sixth anniversary of the date of grant, the total number of stock appreciation rights exercisable may not in aggregate exceed 25%, 50%, 75% and 100%, respectively, of the total stock appreciation rights granted to such person.

In March 2003, our Compensation Committee approved the plan for stock appreciation rights pursuant to which we granted 276 million stock appreciation right units to eligible employees during 2003.

The exercise price of stock appreciation rights granted in 2003 is the initial public offering price of our H shares. Upon exercise of the stock appreciation rights, a recipient will receive, subject to any applicable withholding tax, a cash payment in RMB, translated from the Hong Kong dollar amount equal to the product of the number of stock appreciation rights exercised and the difference between the exercise price and market price of our H shares at the date of exercise based on the applicable exchange rate between RMB and Hong Kong dollar at the date of the exercise.

During the year ended December 31, 2004, 70 million stock appreciation right units were exercised. No stock appreciation right units were exercised in the year ended December 31, 2003.

We recognize compensation expense of the stock appreciation rights over the applicable vesting period. Changes in our payment obligation under the stock appreciation rights plan resulting from changes in fair value of our H shares for the period subsequent to the vesting period through the date of the exercise are also reflected in our earnings. For the year ended December 31, 2004, compensation expense recognized was RMB70 million as compared to RMB97 million for 2003.

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### **C. Board Practices**

#### ***General***

Pursuant to our Articles of Association, our directors must be elected by our shareholders at a general meeting. Our directors are generally elected for a term of three years and may serve consecutive terms if re-elected. All the existing directors have their term expiring on September 9, 2005.

The PRC Company Law requires a joint stock company with limited liability to establish a supervisory committee. Our supervisory committee consists of five supervisors. One member of our supervisory committee must be an employee representative elected by our employees. The remaining members must be appointed by shareholders at a general meeting. The term of office of our supervisors is three years, which is renewable upon re-election or re-appointment. We have entered into service contracts with our directors or supervisors. None of these service contracts provide benefits to our directors upon termination.

#### ***Audit Committee***

The Audit Committee was set up in 2002, and consists of three members, Mr. Zhang Youcai, Mr. Shi Wangpeng and Mr. Vincent Hong Sui Lo. They are all independent non-executive directors. The Audit Committee is accountable to the Board of Directors and reports to it periodically. Usually, the Committee meets at least twice each year. The Articles of Association of the Audit Committee were approved by our Board of Directors in March 2005, according to which, the principal responsibilities of our Audit Committee include supervision of our Company to ensure authenticity and completeness of our financial statements and effectiveness and integration of the internal control system. It also supervises our internal audit department, and is responsible for the review and consideration of the qualification and appointment of independent auditors, and approval of services provided by the independent auditors. The Audit Committee has the power to establish a mechanism for receiving and handling complaints or anonymous reports in respect of our accounting, internal financial control and audit matters.

#### ***Remuneration Committee***

The Remuneration Committee was set up in 2003. It consists of three members, Mr. Zhang Youcai, Mr. Shi Wangpeng and Mr. Vincent Hong Sui Lo, all of whom are independent non-executive directors. The Remuneration Committee is accountable to the Board of Directors and reports to it on its work periodically. Usually, the Remuneration Committee meets at least twice each year. The Articles of Association of the Remuneration Committee were approved by our Board of Directors in March 2005, according to which, its principal responsibilities include ensuring that our remuneration system complies with the relevant regulatory requirements, submitting assessment reports on our remuneration system to the Board of Directors, and presenting recommendations to the Board of Directors on our overall remuneration policy and structure relating to directors and senior management.

### **D. Employees**

**General**

As of December 31, 2004, we had 253,050 employees. The table below sets forth the number of our employees by their functions as of December 31, 2004:

	<u>Number of Employees</u>	<u>% of Total</u>
Management, finance and administrative	40,240	15.90
Sales and marketing	114,872	45.40
Operations and maintenance	96,844	38.27
Others	1,094	0.43
<b>Total</b>	<b>253,050</b>	<b>100.0%</b>

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As of December 31, 2004, we also employed approximately 91,310 temporary employees.

We have implemented a short-term and long-term combined incentive remuneration scheme. The primary components of an employee's remuneration include basic salary, a performance based bonus, compensation based on seniority and stock appreciation rights (stock appreciation rights are exclusively for senior management and senior technological experts). In addition, we also emphasize the importance of employee training and use various means of training to improve the quality and capability of our key employees. We have not been subjected to any strikes or other labor disturbances that have interfered with our operations, and we believe that the relationship between our management and the labor union of our company is good.

**E. Share Ownership**

As of December 31, 2004, none of our directors, supervisors or senior managers is a legal or beneficial owner of any shares of our share capital.

**Item 7. Major Shareholders and Related Party Transactions.****A. Major Shareholders**

The table below sets forth information regarding the ownership of our share capital as of May 23, 2005 by all persons who are known to us to be the beneficial owners of 5% or more of our share capital and certain state-owned shareholders of our company.

<u>Title of Class</u>	<u>Identity of Person or Group</u>	<u>Amount Owned</u>	<u>Percent of Class</u>	<u>Percent of Total Shares<sup>(1)</sup></u>
Domestic shares	China Telecom Group	58,346,370,499	87.01%	72.09%
Domestic shares	Guangdong Rising Assets Management Co., Ltd.	5,614,082,653	8.37%	6.94%
Domestic shares	Zhejiang Financial Development Company	2,137,473,625	3.19%	2.64%
Domestic shares	Jiangsu Guoxin Investment Group Co., Ltd.	957,031,543	1.43%	1.18%

(1) The percentages may not add up to 100% due to rounding discrepancies.

China Telecom Group, located at 31 Jinrong Street, Xicheng District, Beijing, China 100032, is our controlling shareholder and is a wholly state-owned enterprise regulated by the State Council. Guangdong Rising Assets Management Co., Ltd., located at Kai Xuan Hua Mei Da Hotel, 15/F, No. 9, 1 Ming Yue Yi Road, Dongshan District, Guangzhou City, Guangdong Province, China, is a state-owned enterprise owned and controlled by the provincial governments in Guangdong Province. Jiangsu Guoxin Investment Group Co., Ltd., located at 88 Chang Jiang Road, Xuan Wu District, Nanjing City, Jiangsu Province, China, is a state-owned enterprise owned and controlled by the provincial governments in Jiangsu Province. Zhejiang Financial Development Company, located at 1 Huazhe Square, 28/F, Hangzhou City, Zhejiang Province, China, is a state-owned enterprise owned and controlled by the provincial governments in Zhejiang Province. See Item 4. Information on the Company A.



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History and Development of the Company Our Restructuring. None of our major shareholders has voting rights that differ from the voting rights of other shareholders. We are not aware of any arrangement which may at a subsequent date result in a change of control of our company.

In May 2004, we issued 5,318,181,818 new H shares with a par value of RMB1.00 each, by way of a global offering to Hong Kong and overseas investors. As part of the global offering, 531,818,182 existing domestic shares of RMB1.00 each owned by China Telecom Group and the other domestic shareholders were converted into H

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shares and sold to Hong Kong and overseas investors. The table below sets forth information regarding the ownership of our share capital by our state-owned shareholders immediately before and after the global offering and sale of H shares or ADSs, as the case may be, by our state-owned shareholders:

Title of Class	Identity of Person or Group	Amount Owned		Percent of Total Shares before the 2004 Offering	Percent of Total Shares after the 2004 Offering
		before the 2004 Offering	Amount Sold during the Offering		
Domestic shares	China Telecom Group	58,809,120,182	462,749,683	77.78%	72.09%
Domestic shares	Guangdong Rising Assets Management Co., Ltd.	5,658,608,387	44,525,734	7.48%	6.94%
Domestic shares	Zhejiang Financial Development Company	2,154,426,098	16,952,473	2.85%	2.64%
Domestic shares	Jiangsu Guoxin Investment Group Co., Ltd.	964,621,836	7,590,293	1.28%	1.18%

**B. Related Party Transactions**

As of May 23, 2005, China Telecom Group, a wholly state-owned enterprise, directly owned and controlled 72.09% of our issued share capital. Accordingly, transactions between China Telecom Group and us constitute connected transactions under the Hong Kong Stock Exchange Listing Rules.

In connection with our restructuring in 2001 and our acquisitions of telecommunications assets from China Telecom Group on December 31, 2003 and June 30, 2004, respectively, we have entered into various agreements with China Telecom Group and a number of its subsidiaries relating to the mutual provision of ongoing telecommunications and other services. Such agreements include those for trademark licensing, centralized services, interconnection arrangements, optic fiber leasing, property leasing and other services.

Our independent non-executive directors have confirmed that all connected transactions in the year ended December 31, 2004 to which our company was a party:

had been entered into, and the agreements governing those transactions were entered into, by our company in the ordinary and usual course of business;

had been entered into either:

on normal commercial terms; or

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where there was no available comparison to determine whether they are on normal commercial terms, on terms no less favorable than those available to or from independent third parties, as applicable; and

had been entered into on terms that are fair and reasonable so far as the overall interest of the independent shareholders of our company are concerned.

The details of the related party arrangements are described below.

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### ***Arrangements Relating to Our Restructuring and Initial Public Offering***

#### ***Restructuring Agreement***

In connection with our restructuring, we entered into a restructuring agreement with China Telecom Group, whereby China Telecom Group transferred to us substantially all of its assets, liabilities and interests in connection with its wireline telephone, Internet and managed data and leased line services in Shanghai Municipality, Guangdong Province, Jiangsu Province, and Zhejiang Province. Under the restructuring agreement, China Telecom Group has undertaken to indemnify us against any actions, suits, proceedings, claims, losses, damages, payments or other expenses caused by or arising from any assets transferred to us by China Telecom Group due to events that occurred prior to the effective date of our restructuring. China Telecom Group has also agreed to provide certain warranties and indemnities to us against all losses or damages suffered by us as a result of any defective titles of properties owned by independent third parties and sub-leased by us. In addition, under the restructuring agreement, China Telecom Group has undertaken to indemnify us against any liabilities or losses as a result of any adverse effect that agreements entered or to be entered into between China Telecom Group and China Netcom Group may have on our assets and operations or the implementation of our agreements with China Telecom Group. To the extent that China Telecom Group obtains terms and conditions in its arrangements with China Netcom Group in our service regions that are more favorable than the terms and conditions of similar arrangements we have with China Telecom Group, China Telecom Group has undertaken to offer us such comparable terms and conditions.

Furthermore, in accordance with an approval of the Ministry of Information Industry, China Telecom Group shall hold and maintain all licenses received from the Ministry of Information Industry in connection with our businesses for our benefit.

#### ***Letter of Undertakings***

In connection with our restructuring and initial public offering, China Telecom Group has, by a letter of undertakings that is legally binding indefinitely, undertaken that it will support us in our existing operations and future development in the following specific areas that:

we will be the only basic telecommunications services provider under China Telecom Group's control that will have its securities listed on a stock exchange in Hong Kong or outside mainland China;

to the extent within China Telecom Group's control, we will be treated equally with any other operators of wireline telephone, Internet and managed data, leased line and other related telecommunications services that are controlled by China Telecom Group with respect to all approvals, transactions and arrangements between us and China Telecom Group and/or operators controlled by China Telecom Group; and

we will have the right to provide additional telecommunications services in our service regions that fall within China Telecom Group's scope of business (including the trial and commercial application of new telecommunications technologies and provision of new telecommunications services). In addition, we will have a preferential right to acquire China Telecom Group's interest in companies or other entities that provide telecommunications services.

We expect that China Telecom Group will implement its undertaking of extending support to us by honoring its specific commitments set forth above. The current terms of the letter of undertakings do not obligate China Telecom Group to provide any financial support to us. See Item 3. Key Information D. Risk Factors Risks Relating to Our Business The letter of undertakings provided to us by China Telecom Group contains

vague terms that may not be implemented as we expect.

***Non-Competition Agreement***

Under a non-competition agreement between our Company and China Telecom Group, China Telecom Group has undertaken to us that, for so long as our shares are listed on the Hong Kong Stock Exchange or any other

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exchange, and China Telecom Group holds over 30% of our issued share capital or China Telecom Group is regarded as our controlling shareholder in accordance with the Hong Kong Stock Exchange Listing Rules, China Telecom Group will not at any time, directly or indirectly, provide basic telecommunications services or selected value-added telecommunications services, in our service regions that may compete with us.

We entered into a supplemental connected transactions agreement with China Telecom Group on October 26, 2003. Pursuant to the supplemental connected transactions agreement, the definition of "basic telecommunications services" is amended to include all basic telecommunications services under the regulations of the Ministry of Information Industry, promulgated on February 21, 2003, and the definition of "value-added services" is also amended to include domestic multi-parties telecommunications services, Internet access services, Internet data center services, Internet VPN services and VPN services.

### ***Apportionment of International Settlement***

We have agreed, on our and China Telecom Group's behalf, to settle any amounts due to or receive any amounts due from a foreign telephone operator in respect of international calls made between China and the relevant foreign country. Amounts will be due from a foreign telephone operator to us and/or China Telecom Group if over a period the volume of inbound calls exceeds the volume of outbound calls. Conversely, amounts will be due to a foreign telephone operator from us and/or China Telecom Group if over a period the volume of outbound calls originating from us and China Telecom Group exceeds the volume of inbound calls. Any amounts due to or due from a particular foreign telephone operator will then be settled between China Telecom Group and us on the basis of the net volume of telephone calls originating from or terminated by China Telecom Group and us respectively in relation to that foreign telephone operator. For the year ended December 31, 2004, the net amount of international settlement we paid was RMB47 million.

### ***Inter-provincial Prepaid Telephone Card Settlement***

We and China Telecom Group have agreed to share the revenue derived from calls made on inter-provincial prepaid telephone cards purchased within our service regions and used outside our service regions in China and vice versa. Revenue from calls made by using certain prepaid telephone cards, including integrated circuit cards and codified cards, will be allocated entirely to the operator from whose service region the call was made.

### ***Arrangements Relating to the Acquisitions***

#### ***Indemnification***

In connection with the acquisition of telecommunications assets from China Telecom Group by our Company, under the Sale and Purchase Agreement, dated October 26, 2003, between our Company and China Telecom Group, China Telecom Group has undertaken to indemnify Anhui Telecom Company Limited, Fujian Telecom Company Limited, Jiangxi Telecom Company Limited, Guangxi Telecom Company Limited, Chongqing Telecom Company Limited and Sichuan Telecom Company Limited for any loss or damages suffered by those companies as a result of, or related to, the reorganization of those companies under which China Telecom Group transferred to those companies the telecommunications operations of China Telecom Group in Anhui Province, Fujian Province, Jiangxi Province, Guangxi Zhuang Autonomous Region, Chongqing Municipality and Sichuan Province, and for any loss or damages suffered by those companies in connection with events

preceding such reorganization.

In connection with the acquisition of telecommunications assets from China Telecom Group by our Company, under the Conditional Sale and Purchase Agreement, dated April 13, 2004, between our Company and China Telecom Group, China Telecom Group has undertaken to indemnify and keep indemnified us against any loss or liability suffered by us or any acquired company including, but not limited to, any diminution in the value of the assets of or shares in any acquired company, any payment made or required to be made by us or any acquired company and any costs and expenses incurred as a result of or in connection with any claim falling on any acquired company resulting from or by reference to any income, profits or gains earned, accrued or received on or before the date of the acquisition or any event on or before the date of the acquisition whether alone or in conjunction with other circumstances and whether or not such taxation is chargeable against or attributable to any other person, firm or company.

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### ***Ongoing Related Party Transactions between Us and China Telecom Group***

On September 10, 2002, we entered into various agreements with China Telecom Group, effective as of January 1, 2002, relating to the provision of ongoing telecommunications and other services in Shanghai Municipality, Guangdong Province, Jiangsu Province and Zhejiang Province. On October 26, 2003, we entered into various supplemental agreements with China Telecom Group, effective December 31, 2003, relating to the provision of ongoing telecommunications and other services in all of our service regions.

On April 13, 2004, our Company and China Telecom Group entered into Supplemental Trademark License Agreement, and Supplemental Agreement Regarding Non-competition Agreement, Centralized Service Agreement, Interconnection Settlement Agreement, Provincial Optic Cable Line Leasing Agreement, effective June 30, 2004. Also on April 13, 2004, Our Company and China Telecom Group entered into Comprehensive Service Agreement, with retrospective effect from January 1, 2004. On December 30, 2004, the Centralized Services Agreement, the Comprehensive Services Agreement, the Property Leasing Agreements, the Property Sub-leasing Agreements, the IT Services Agreements, and the Equipment Procurement Agreements were renewed for further periods of one year.

### ***Trademark License Agreements***

China Telecom Group has registered a number of trademarks, and is in the process of registering other trademarks with the State Trademark Office under the PRC State General Administration for Industry and Commerce. Under the trademark license agreement dated September 10, 2002 and the supplemental trademark license agreements dated October 26, 2003 and April 13, 2004, China Telecom Group has granted to our Company and our subsidiaries a right to use its registered trademarks and its trademarks pending registration on a royalty-free basis. The license granted under the trademark license agreement and the supplemental trademark license agreement will expire on December 31, 2006 and is automatically renewable for further periods of three years at our option.

### ***Centralized Services Agreements***

The Centralized Services Agreement was renewed on December 30, 2004 and may be renewed for further periods of one year upon expiration. The aggregate costs incurred by China Telecom Group and us for the provision of management services relating to the operation of the business support centre and the network management centre, the costs of headquarters and certain network support premises and related facilities (including labor costs, depreciation of equipment and premises, daily expenses, costs relating to maintenance and research) and certain large corporate customers of the headquarters of China Telecom Group, will be apportioned on a pro rata basis between China Telecom Group and us according to the revenues generated by each party. In relation to the use of the international telecommunications facilities, our Company and China Telecom Group have agreed to apportion the costs associated with operating such assets on a pro rata basis according to the aggregate volume of the inbound international calls terminated by, and outbound international calls originated from, China Telecom Group and us, respectively.

Prior to our restructuring, no such arrangement was in effect between China Telecom Group and us. For the year ended December 31, 2004, our portion of the costs in respect of the use of international telecommunications facilities and other centralized services were RMB91 million and RMB72 million, respectively.

### ***Interconnection Agreement***



The interconnection agreement dated September 10, 2002 and the supplemental connected transactions agreement dated October 26, 2003 and April 13, 2004 that we entered into with China Telecom Group allow our domestic telephone networks to interconnect with China Telecom Group's domestic networks outside our service regions. This agreement will expire on December 31, 2006 and can be extended for three years with no times limit unless we give China Telecom Group written notice to terminate three months before the expiration date. The

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interconnection agreement does not provide for early termination or non-renewal by China Telecom Group. Interconnection settlement charges between China Telecom Group's networks and our networks are based on fees prescribed by the Ministry of Information Industry from time to time, which is currently RMB0.06 per minute. The formula for settlement is based on the net volume of telephone calls originating from us to China Telecom Group or originating from China Telecom Group to us multiplied by the Ministry of Information Industry's prescribed settlement fees. The interconnection agreement stipulates that the settlement be made between us and China Telecom Group on a monthly basis, with the operator that has originated more calls paying the net amount to the operator that has terminated more calls.

For the year ended December 31, 2004, the net settlement payment made by us to China Telecom Group pursuant to the interconnection agreement was RMB103 million.

### ***Optic Fiber Leasing Agreement***

We lease from China Telecom Group the inter-provincial transmission optic fibers in Shanghai Municipality, Guangdong Province, Jiangsu Province and Zhejiang Province, which our telecommunications services are dependent upon, under an optic fiber leasing agreement dated September 10, 2002 and the supplemental connected transactions agreement dated October 26, 2003 and April 13, 2004, respectively. The optic fiber leasing agreement will expire on December 31, 2006 and is automatically renewable for three more years at our option. The amount payable from us to China Telecom Group to lease the relevant parts of the inter-provincial transmission optic fibers will be based on the depreciation charge for the optic fibers within those regions, calculated on the basis of the carrying value of the optic fibers. In addition, we agreed to be responsible for the maintenance of these optic fibers within those service regions.

For the year ended December 31, 2004, the total amount we paid to China Telecom Group with respect to the leasing of optic fibers was RMB99 million.

### ***Comprehensive Services Framework Agreement***

The Comprehensive Services Agreement was entered into between China Telecom Group and our Company on April 13, 2004 and was renewed on December 30, 2004. This agreement will be renewed for further periods of one year upon expiration unless terminated by either party by giving at least three months' written notification to the other party in advance.

This agreement governs the terms and conditions of transactions on two levels: (i) between our Company and certain associates held by China Telecom Group as long-term investments; and (ii) between our Company and certain subsidiaries of China Telecom Group operating in other provinces, or Provincial Subsisting Companies. Such transactions include procurement of telecommunications equipment such as optic fiber, network designs, software upgrade, system integration, manufacture of calling cards and so on. Prices under such agreement should be determined in accordance with the government-prescribed prices. In the absence of the government-prescribed prices, the government-guided prices (if any) shall apply. In the absence of both government-prescribed prices and government-guided prices, the market prices shall apply, i.e., the prices at which the same type of services is provided by independent third party in the ordinary course of business. If none of such prices is applicable, the prices shall be determined through agreements between the parties based on reasonable costs plus reasonable profits. For this purpose, reasonable costs shall mean the costs determined by the parties after negotiations.

For the year ended December 31, 2004, our expenditure on the comprehensive services pursuant to the Comprehensive Services Agreement was RMB361 million.

***Ongoing Related Party Transactions between Our Subsidiaries and Subsidiaries of China Telecom Group***

After our restructuring in connection with our initial public offering in 2001 and our acquisitions of telecommunications assets from China Telecom Group on December 31, 2003 and June 30, 2004, respectively, certain ancillary and mostly non-telecommunications related businesses and assets within our service regions are operated or held by certain subsidiaries of China Telecom Group.

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### ***Engineering Framework Agreements***

The Engineering Framework Agreements will expire on December 31, 2006, and may be renewed for further periods of three years upon expiration. These agreements set out provisions in respect of the supervision and management of services relating to construction, design, and equipment installation and tests provided to our subsidiaries by the Provincial Subsisting Companies through bidding, and/or services as the general contractors for the construction and supervision of engineering projects of our subsidiaries. The charges payable for such engineering services shall be determined by reference to market rates as reflected by prices obtained through tender process.

For the year ended December 31, 2004, our expenditure on engineering services under the engineering agreements was RMB6,376 million.

### ***Property Leasing Framework Agreements***

The Property Leasing Framework Agreements were renewed on December 30, 2004 and may be renewed for further periods of one year upon expiration. Pursuant to such agreements, our subsidiaries lease properties from the Provincial Subsisting Companies for use as business premises, offices, equipment storage facilities and sites for network equipment. On the other hand, our subsidiaries also lease certain properties to the Provincial Subsisting Companies. The rent shall be determined based on the market price with reference to the standard set forth by local pricing authorities.

For the year ended December 31, 2004, our expenditure on rental charges was RMB319 million. For the same period, the rental income derived from the subsidiaries of China Telecom Group was RMB25 million.

### ***Properties Sub-leasing Framework Agreements***

The Property Sub-Leasing Framework Agreements were renewed on December 30, 2004 and may be renewed for further periods of one year upon expiration. Pursuant to such agreements, the Provincial Subsisting Companies sublease certain properties owned and leased by independent third parties to our subsidiaries for use as offices, retail outlets, spare parts storage facilities and sites for network equipment. The rent for sub-leasing of third party property shall be determined based on the market price as agreed between the relevant Provincial Subsisting Company and relevant third party through arm's length negotiation.

For the year ended December 31, 2004, our expenditure in relation to third party properties sub-leasing was RMB93 million.

### ***IT Services Framework Agreements***

The IT Services Framework Agreements were renewed on December 30, 2004 and may be renewed for further periods of one year upon expiration. Pursuant to such agreements, the Provincial Subsisting Companies may participate in the bidding for the right to provide our

subsidiaries with certain information technology services, such as office automation and software upgrade. The charges payable for such IT services shall be determined by reference to market rates or as determined by prices obtained through the tender process.

For the year ended December 31, 2004, our expenditure on information technology services provided by the subsidiaries of China Telecom Group to us was RMB192 million.

*Equipment Procurement Services Framework Agreements*

The Equipment Procurement Services Framework Agreements were renewed on December 30, 2004 and may be renewed for further periods of one year upon expiration. Pursuant to such agreements, the Provincial Subsisting Companies have agreed to provide comprehensive procurement services, including management of tenders, verification of technical specifications and installation services. The maximum commission for such procurement

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services shall be calculated based on the following: (1) not more than 1% of the contract value for procurement of imported telecommunications equipment; or (2) not more than 3% of the contract value for the procurement of domestic telecommunications equipment and other domestic non-telecommunications materials.

For the year ended December 31, 2004, our expenditure incurred under such agreements was RMB304 million.

### ***Community Services Framework Agreements***

The Community Services Framework Agreements will expire on December 31, 2006, and may be renewed for further periods of three years upon expiration. Pursuant to such agreements, the Provincial Subsisting Companies will provide our subsidiaries with services relating to culture, education, property management, vehicle service, medical care, hotel and conference service, community and sanitary services. The pricing terms for such services are the same as those for comprehensive services.

For the year ended December 31, 2004, our expenditure on services available to us under the community services agreements was RMB2,417 million.

### ***Ancillary Telecommunications Services Framework Agreements***

The Ancillary Telecommunications Services Framework Agreements will expire on December 31, 2006, and may be renewed for further periods of three years upon expiration. Pursuant to such agreements, the Provincial Subsisting Companies agree to provide our subsidiaries with certain repair and maintenance services, including maintenance of telecommunications equipment, fire equipment and telephone booths, as well as other customer services. The pricing terms for such services are the same as those for comprehensive services.

For the year ended December 31, 2004, our expenditure on services available to us under the ancillary telecommunications agreements was RMB2,490 million.

### ***Special Communications Services Agreements***

Subsidiaries of China Telecom Group have retained the assets required to provide special communications services such as telecommunications services provided to certain government agencies and under emergency circumstances. Under the special communications service agreements we entered into with subsidiaries of China Telecom Group, China Telecom Group has agreed to lease from us the general telecommunications infrastructure required to provide the special communications services within our service regions. These agreements will expire on December 31, 2006 and will be automatically renewed for three more years unless either party decides not to renew. China Telecom Group has agreed to reimburse us for the leasing of the infrastructure in connection with the special communications services on a basis prescribed by the Ministry of Industry Information. In addition, we have agreed to provide the necessary human resources to maintain and operate the special communications services within our service regions in return for China Telecom Group reimbursing us for the costs we incur in providing such services, including the cost for the network operation support, general and administrative expenses and certain other operating expenses.

For the year ended December 31, 2004, our income for special communications services provided to China Telecom Group was RMB25 million.

**C. Interests of Experts and Counsel**

Not applicable.

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### **Item 8. Financial Information.**

#### **A. Consolidated Financial Statements**

Our audited consolidated financial statements are set forth beginning on page F-1.

#### ***Legal Proceeding***

We are the defendant in certain lawsuits and a named party in other legal proceedings arising in the ordinary course of business. While the outcomes of such contingencies, lawsuits or other legal proceedings cannot be determined at present, we believe that the outcomes of such contingencies, lawsuits or other legal proceedings will not likely result in any material adverse effect on our financial position or results of operations.

#### ***Policy on Dividend Distributions***

Pursuant to the shareholders' approval at the annual general meeting held on May 3, 2004, a final dividend of RMB5,224 million (RMB0.069083 equivalent to HK\$0.065 per share) in respect of the year ended December 31, 2003 was declared and paid on May 20, 2004. Pursuant to the shareholders' approval at the annual general meeting held on June 20, 2003, a final dividend of RMB673 million (RMB0.008897 per share) in respect of the year ended December 31, 2002 was declared and paid on July 10, 2003. Pursuant to a resolution passed at the Directors' meeting on March 31, 2005, a final dividend of equivalent to HK\$0.065 per share totalling approximately RMB5,576 million for the year ended December 31, 2004 was proposed for shareholders' approval at the annual general meeting. The dividend has not been provided for in the consolidated financial statements for the year ended December 31, 2004.

The declaration and payment of dividends for years following 2004 will depend upon our financial results, our shareholders' interests, general business conditions and strategies, our capital requirements, contractual restrictions on the payment of dividends by us to our shareholders or by our subsidiaries to us, if any, possible effects on our credit worthiness and other factors our directors may deem relevant. Our board of directors will declare dividends, if any, in Renminbi with respect to our H shares on a per share basis and will pay such dividends in Hong Kong dollars. Any final dividend for a fiscal year will be subject to shareholders' approval. Under the PRC Company Law and our articles of association, all of our shareholders have equal rights to dividends and distributions. The holders of our H shares will share proportionately on a per share basis in all dividends and other distributions declared by our Company.

The Bank of New York, as depositary, will convert the Hong Kong dollar dividend payment and distribute it to holders of ADSs in U.S. dollars, less related fees and expenses and any withholding tax.

### **Item 9. The Offer and Listing.**



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In connection with our initial public offering, our ADSs were listed and commenced trading on the New York Stock Exchange on November 14, 2002 under the symbol CHA . Our H shares were listed and commenced trading on the Hong Kong Stock Exchange on November 15, 2002. Prior to these listings, there was no public market for our equity securities. The New York Stock Exchange and the Hong Kong Stock Exchange are the principal trading markets for our ADSs and H shares, which are not listed on any other exchanges in or outside the United States.

As of December 31, 2004 and May 23, 2005, there were 13,877,410,000 H shares issued and outstanding. As of December 31, 2004 and May 23, 2005, there were, respectively, 16 and 8 registered holders of American depositary receipts evidencing 8,452,947 and 7,126,587 ADSs. Since certain of the ADSs are held by nominees, the above number may not be representative of the actual number of U.S. beneficial holders of ADSs or the number of ADSs beneficially held by U.S. persons. The depository for the ADSs is The Bank of New York.

The high and low closing sale prices of the shares on the Hong Kong Stock Exchange and of the ADSs on the NYSE for the periods indicated are as follows.

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	Price per Share (HK\$)		Price per ADS (US\$)	
	High	Low	High	Low
<b>Annual</b>				
2002 (from listing date)	1.49	1.37	18.80	17.27
2003	3.20	1.34	40.81	17.00
2004	3.45	2.25	44.54	28.25
<b>Quarterly</b>				
First Quarter, 2003	1.52	1.34	19.42	17.00
Second Quarter 2003	1.84	1.34	23.15	17.31
Third Quarter 2003	2.33	1.78	30.00	22.63
Fourth Quarter 2003	3.20	2.05	40.81	26.12
First Quarter, 2004	3.45	2.55	44.54	33.20
Second Quarter 2004	2.83	2.25	35.98	28.25
Third Quarter 2004	2.75	2.43	34.87	31.34
Fourth Quarter 2004	3.00	2.48	38.39	31.53
First Quarter, 2005	3.08	2.65	39.31	34.26
<b>Monthly</b>				
December 2004	3.00	2.75	38.39	35.45
January 2005	2.90	2.65	37.33	34.26
February 2005	3.08	2.90	39.31	37.08
March 2005	2.95	2.65	38.08	34.55
April 2005	2.80	2.60	35.85	33.45
May 2005 (through May 23)	2.75	2.63	35.09	33.45

**Item 10. Additional Information.****A. Share Capital**

Not applicable.

**B. Articles of Association**

The section entitled "Description of Share Capital" contained in our registration statement on Form F-3 (File No. 333-113181) filed with the Securities and Exchange Commission is hereby incorporated by reference. We also filed our amended articles of association with the Securities and Exchange Commission as exhibits to our Form 6-Ks (File No. 001-31517) on June 10, 2004 and October 21, 2004, respectively.

Our shareholders approved certain amendments to our articles of association at the annual general meetings held on June 9, 2004 and October 20, 2004, respectively, in Beijing, China.

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Pursuant to the annual general meeting held on June 9, 2004, provisions relating to the service areas of our Company of the articles of association of our Company were amended from ten provinces (autonomous regions, municipalities directly under the central government), namely Shanghai, Guangdong, Jiangsu, Zhejiang, Anhui, Fujian, Jiangxi, Guangxi, Chongqing and Sichuan to twenty provinces (autonomous regions, municipalities directly under the central government), namely Shanghai, Guangdong, Jiangsu, Zhejiang, Anhui, Fujian, Jiangxi, Guangxi, Chongqing, Sichuan, Hubei, Hunan, Hainan, Guizhou, Yunnan, Shaanxi, Gansu, Qinghai, Ningxia and Xinjiang. In addition, in order to comply with the newly amended Listing Rules of Hong Kong Stock Exchange, Article 6 was restated as follows: "In accordance with the provisions of the Company Law, the Special Regulations and the Mandatory Provisions for Articles of Association of Companies Listing Overseas (the Mandatory Provisions) and other PRC laws and administrative regulations, the Company convened its general meeting on June 9, 2004 to further amend the articles of association of the Company lastly amended in a general meeting of the Shareholders on June 20, 2003 and adopt these articles of association." The following paragraph: "Where any member, under the Listing Rules, is required to abstain from voting on any particular resolution or is restricted to voting only for or only against any particular resolution, any votes cast by or on behalf of such member in contravention of such

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requirement or restriction shall not be counted was added to the end of Article 65. The second paragraph of Article 95 was replaced by The minimal length of the period during which written notice to the Company of the intention to propose a person for election as a director, and during which written notice to the Company by such person of his willingness to be elected may be given, will be at least 7 days. Such period will commence no earlier than the day after the despatch of the notice of the meeting appointed for such election and end no later than 7 days prior to the date of such meeting .

Pursuant to the resolution passed on the annual general meeting held on October 20, 2004, (a) Article 6 of the Articles of Association was amended as The Company s Articles of Association (the Articles of Association or these Articles of Association ) are enacted in accordance with the provisions of the Company Law, the Special Regulations and the Mandatory Provisions for Articles of Association of Companies to be Listed Overseas (the Mandatory Provisions ) and other PRC laws and administrative regulations. (b) Article 20 was amended as By the approval of the relevant companies department authorized by the State Council, the Company may issue a total of 80,932,368,321 ordinary shares, of which 68,317,270,803 were issued to the promoter of the Company at the time when the Company was established, representing 84.41% of the entire issued share capital. (c) Article 21 was amended as All the 12,615,097,518 ordinary shares issued by the Company after its incorporation are the overseas-listed foreign-invested shares (H Shares). Pursuant to the Provisional Measures on the Administration of the Reduction of the State-Owned Shares for Raising Social Security Funds, the number of overseas-listed foreign-invested shares (H Shares) converted from a reduction by holders of State-owned shares of their shareholdings of the State-owned shares amounted to 1,262,312,482 shares. The total of the overseas-listed foreign-invested shares (H Shares) issued by the Company shall be 13,877,410,000 shares, representing 17.15% of the issued share capital of the Company. The share capital structure of the Company is as follows: there are a total of 80,932,368,321 ordinary shares issued, of which 58,346,370,499 shares are held by the promoter, China Telecommunications Corporation, representing 72.09% of the total of the ordinary shares issued by the Company. The other holders of the domestic shares are Guangdong Rising Assets Management Co., Ltd., holding a total of 5,614,082,653 shares representing 6.94% of the total of the ordinary shares issued by the Company, Jiangsu Guoxin Investment Group Co., Ltd., holding a total of 957,031,543 shares representing 1.18% of the total of the ordinary shares issued by the Company, and Zhejiang Financial Development Company, holding a total of 2,137,473,626 shares representing 2.64% of the total of the ordinary shares issued by the Company. A total of 13,877,410,000 overseas-listed foreign-invested shares are held by holders of overseas-listed foreign-invested shares, representing 17.15% of the total of the ordinary shares issued by the Company. (d) Article 24 was amended as The registered capital of the Company shall be RMB80,932,368,321. (e) The first paragraph of Article 94 was amended as The Company shall have a board of directors. The board of directors shall consist of fifteen (15) directors, of which three (3) shall be independent (non-executive) directors (meaning directors who are independent from the Company s shareholders and do not hold office in the Company hereinafter). (f) The second paragraph of Article 133 was amended as If a director or his associate (as defined in the Rules Governing the Listing of Securities of The Stock Exchange of Hong Kong Limited) has a material interest in any contract, transaction, arrangement or other matters that requires the approval of the board of directors, the relevant director shall not vote for the relevant matter at the meeting of the board of directors, and shall not be listed in the quorum of the meeting.

**C. Material Contracts**

See Item 7. Major Shareholders and Related Party Transactions B. Related Party Transactions for certain arrangements we have entered into with China Telecom Group.

**D. Exchange Controls**

We conduct our business primarily in Renminbi, which is also our functional and reporting currency. The Renminbi is not a fully-convertible currency. Under China s existing foreign exchange regulations, we will be able to pay dividends in foreign currencies without prior approval from the State Administration of Foreign Exchange by complying with certain procedural requirements. However, the Chinese government may take measures at its discretion in the future to restrict access to foreign currencies for both current account transactions and capital account transactions if foreign currencies become scarce in China. We may not be able to pay dividends in foreign currencies to our shareholders, including holders of our ADRs, if the Chinese government restricts access to foreign currencies for current account transactions.



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Foreign exchange transactions under our capital account, including foreign currency-denominated borrowings from foreign banks, issuance of foreign currency-denominated debt securities and principal payments in respect of foreign currency-denominated obligations, continue to be subject to significant foreign exchange controls and require the approval of the State Administration of Foreign Exchange. These limitations could affect our ability to obtain foreign exchange through debt or equity financing, or to obtain foreign exchange to meet our payment obligations under the debt securities or foreign exchange for capital expenditures.

There are no limitations on the right of non-resident or foreign owners to remit dividends or to hold or vote the ordinary shares or the ADSs imposed by Hong Kong law or by our articles of association or other constituent documents.

## **E. Taxation**

*The taxation of income and capital gains of holders of H shares or ADSs is subject to the laws and practices of China and of jurisdictions in which holders of H shares or ADSs are resident or otherwise subject to tax. The following summary of certain relevant taxation provisions is based on current law and practice, is subject to change and does not constitute legal or tax advice. The discussion does not deal with all possible tax consequences relating to an investment in the H shares or ADSs. In particular, the discussion does not address the tax consequences under state, local and other laws, such as non-U.S. federal laws. Accordingly, you should consult your own tax adviser regarding the tax consequences of an investment in the H shares and ADSs. The discussion is based upon laws and relevant interpretations in effect as of the date of this annual report, all of which are subject to change.*

### *People's Republic of China*

The following is a summary of certain Chinese tax provisions relating to the ownership and disposition of H shares or ADSs held by the investors as capital assets. This summary does not purport to address all material tax consequences of the ownership of H shares, and does not take into account the specific circumstances of any particular investors. This summary is based on the tax laws of China as in effect on the date of this annual report, as well as on the Agreement between the United States of America and the People's Republic of China for the Avoidance of Double Taxation, or the PRC-US Treaty, all of which are subject to change (or changes in interpretation), possibly with retroactive effect.

This discussion does not address any aspects of Chinese taxation other than income taxation, capital taxation, stamp taxation and estate taxation. Prospective investors are urged to consult their tax advisors regarding Chinese, Hong Kong and other tax consequences of owning and disposing of H shares.

### *Taxation of Dividends*

*Individual Investors.* According to the Provisional Regulations of China Concerning Questions of Taxation on Enterprises Experimenting with the Share System, or the Provisional Regulations, and the Individual Income Tax Law of China, as amended on August 30, 1999, dividends paid by Chinese companies are ordinarily subject to a Chinese withholding tax levied at a flat rate of 20%. For a foreign individual who is not a resident of China, the receipt of dividends from a company in China is normally subject to a withholding tax of 20% unless reduced by an applicable tax treaty. However, the Chinese State Administration of Taxation, or the SAT, the Chinese central government tax authority which succeeded the State Tax Bureau, issued, on July 21, 1993, a Notice of the Chinese State Administration of Taxation Concerning the Taxation of Gains on Transfer and Dividends from Shares (Equities) Received by Foreign Investment Enterprises, Foreign Enterprises and Foreign

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Individuals, or the Tax Notice, which states that dividends paid by a Chinese company to individuals with respect to shares listed on an overseas stock exchange, or Overseas Shares, such as H shares, are not subject to Chinese withholding tax. The relevant tax authority has not collected withholding tax on dividend payments on Overseas Shares, including H shares and ADSs.

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Under the Individual Income Tax Law of China, foreign individuals are subject to withholding tax on dividends paid by a Chinese company at a rate of 20% unless specifically exempted by the tax authority of the State Council. However, in a letter dated July 26, 1994 to the former State Commission for Restructuring the Economic System, the former State Council Securities Commission and the China Securities Regulatory Commission, the SAT reiterated the temporary tax exemption stated in the Tax Notice for dividends received from a Chinese company listed overseas. In the event that this letter is withdrawn, a 20% tax may be withheld on dividends in accordance with the Provisional Regulations, the Amendments and the Individual Income Tax Law. Such withholding tax may be reduced under an applicable double taxation treaty. To date, the relevant tax authorities have not collected withholding tax from dividend payments on such shares exempted under the Tax Notice.

*Enterprises.* According to the Income Tax Law of China Concerning Foreign Investment Enterprises and Foreign Enterprises, dividends paid by Chinese companies to enterprises are ordinarily subject to a Chinese withholding tax levied at a flat rate of 20%. However, according to the Tax Notice, a foreign enterprise with no permanent establishment in China receiving dividends paid with respect to a Chinese company's Overseas Shares will temporarily not be subject to the 20% withholding tax. If such withholding tax becomes applicable in the future, the rate could be reduced under an applicable double taxation treaty.

*Tax Treaties.* Investors who do not reside in China and reside in countries that have entered into double-taxation treaties with China may be entitled to a reduction of the withholding tax imposed on the payment of dividends to investors of our company who do not reside in China. China currently has double-taxation treaties with a number of other countries, which include:

Australia;

Canada;

France;

Germany;

Japan;

Malaysia;

the Netherlands;

Singapore;

the United Kingdom; and

the United States.



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Under the China-US Treaty, China may tax a dividend paid by us to an Eligible U.S. Holder up to a maximum of 10% of the gross amount of such dividend. It is arguable that under the China-US Treaty, China may only tax gains from the sale or disposition by an Eligible U.S. Holder of H shares representing an interest in the Company of 25% or more, but this position is uncertain and the Chinese authorities may take a different position. For the purposes of this discussion, an Eligible U.S. Holder is a U.S. holder that (i) is a resident of the United States for the purposes of the China-US Treaty, (ii) does not maintain a permanent establishment or fixed base in China to which H shares are attributable and through which the beneficial owner carries on or has carried on business (or, in the case of an individual, performs or has performed independent personal services) and (iii) is not otherwise ineligible for benefits under the China-US Treaty with respect to income and gains derived in connection with the H shares.

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### ***Taxation of Capital Gains***

The Tax Notice provides that gains realized by enterprises that are holders of Overseas Shares would, temporarily, not be subject to capital gains taxes. With respect to individual holders of H shares, the Provisions for Implementation of Individual Income Tax Law of China, or the Provisions, issued on January 28, 1994, stipulated that gains realized on the sale of equity shares would be subject to income tax at a rate of 20% on the gains, and empowered the Ministry of Finance to draft detailed tax rules on the mechanism for collecting such tax, as per the official publication *China Securities News* of April 13, 1994. However, no income tax on gains realized on the sale of equity shares has been collected. Gains on the sale of shares by individuals were temporarily exempted from individual income tax pursuant to notices issued by the SAT dated June 20, 1994, February 9, 1996 and March 30, 1998. In the event this temporary exemption is withdrawn or ceases to be effective, individual holders of H shares may be subject to capital gains tax at the rate of 20% unless such tax is reduced or eliminated by an applicable double taxation treaty. If tax on capital gains from the sale of H shares become applicable, it is arguable that under the China-US Treaty, China may only tax gains from the sale or disposition by an Eligible U.S. Holder of H shares representing an interest in our company of 25% or more, but this position is uncertain and the Chinese authorities may take a different position.

On November 18, 2000, the State Council issued a notice entitled *State Council Notice on the Income Tax Reduction for Interest and Other Income that Foreign Enterprises Derive in China*, or the Tax Reduction Notice. Under the Tax Reduction Notice, beginning January 1, 2001, enterprise income tax at a reduced 10% rate will apply to interest, rental, license fees and other income obtained in China by foreign enterprises without agencies or establishment in China, or by foreign enterprises without any substantive relationship with their agency or establishment in China. Therefore, if the exemption as described in the preceding paragraph does not apply or is not renewed, and the Tax Reduction Notice is found not to apply, a foreign enterprise shareholder may be subject to a 20% tax on capital gains, unless reduced by an applicable double taxation treaty.

### ***Additional Chinese Tax Considerations***

*Chinese Stamp Duty.* Chinese stamp duty imposed on the transfer of shares of Chinese publicly traded companies under the Provisional Regulations should not apply to the acquisition and disposal by non-Chinese investors of H shares or ADSs outside of China by virtue of the Provisional Regulations of China Concerning Stamp Duty, which became effective on October 1, 1988 and which provide that Chinese stamp duty is imposed only on documents executed or received within China that are legally binding in China and are protected under Chinese law.

*Estate Tax.* No liability for estate tax under Chinese law will arise from non-Chinese nationals holding H shares.

### ***Hong Kong***

#### ***Tax of Dividends***

Under the current practice of the Hong Kong Inland Revenue Department, no tax is payable in Hong Kong in respect of dividends paid by us.

*Profits*

No tax is imposed in Hong Kong in respect of capital gains from the sale of property, such as an H share. Trading gains from the sale of property by persons carrying on a trade, profession or business in Hong Kong where such gains are derived from or arise in Hong Kong from such trade, profession or business will be chargeable to Hong Kong profits tax, which is currently imposed at the rate of 17.5% on corporations with effect from April 1, 2003 and 16.0% on individuals with effect from April 1, 2004. Gains from sales of H shares effected on the Hong Kong Stock Exchange will be considered to be derived from or arise in Hong Kong. Liability for Hong Kong profits tax would thus arise in respect of trading gains from sales of H shares realized by persons carrying on a business of trading or dealing in securities in Hong Kong. There is no tax treaty in effect between the United States and Hong Kong, and the PRC-US Treaty does not apply to Hong Kong.

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There will be no liability for Hong Kong profits tax in respect of profits from the sale of ADSs, where purchases and sales of ADSs are effected outside Hong Kong, e.g., on the New York Stock Exchange.

### ***Stamp Duty***

Hong Kong stamp duty will be payable by the purchaser on every purchase and by the seller on every sale of H shares registered on the Hong Kong branch register. The duty is charged at the ad valorem rate of 0.1% of the consideration for, or (if greater) the value of, the H shares transferred on each of the seller and the purchaser. In other words, a total 0.2% is currently payable on a typical sale and purchase transaction of H shares. In addition, a fixed duty of HK\$5 is currently payable on any instrument of transfer of shares.

If one of the parties to the sale is a non-resident of Hong Kong and does not pay the required stamp duty, the duty not paid will be assessed on the instrument of transfer (if any), and the transferee will be liable for payment of such duty.

The withdrawal of H shares upon the surrender of ADRs, and the issuance of ADRs upon the deposit of H shares, will also attract stamp duty at the rate described above for sale and purchase transactions unless such withdrawal or deposit does not result in a change in the beneficial ownership of the H shares under Hong Kong law. The issuance of the ADRs upon the deposit of H shares issued directly to the Depository, as depository of the ADSs, or for the account of the Depository, will not be subject to any stamp duty. No Hong Kong stamp duty is payable upon the transfer of ADSs outside Hong Kong.

### ***Estate Duty***

The H shares are Hong Kong property under Hong Kong law, and accordingly, these shares may be subject to estate duty on the death of the beneficial owner of these shares, regardless of the place of the owner's residence, citizenship or domicile. We cannot assure you that the Hong Kong Inland Revenue Department will not treat the ADSs as Hong Kong property that may be subject to estate duty on the death of the beneficial owner of the ADS even if the ADRs evidencing such ADSs are located outside Hong Kong at the date of such death. Hong Kong estate duty is imposed on a progressive scale from 5% to 15%. The rate of and the threshold for estate duty has, in the past, been adjusted on a fairly regular basis. No estate duty is payable when the aggregate value of the dutiable estate does not exceed HK\$7.5 million, and the maximum rate of duty of 15% applies when the aggregate value of the dutiable estate exceeds HK\$10.5 million.

### ***United States***

#### ***United States Federal Income Taxation***

This section describes the material United States federal income tax consequences of the acquisition, ownership and disposition of H shares or ADSs. It applies to you only if you are a U.S. holder, as described below, and you hold your H shares or ADSs as capital assets for United States federal income tax purposes. This section does not apply to you if you are a member of a special class of holders subject to special rules, including:

a bank;

a dealer in securities or currencies;

a trader in securities that elects to use a mark-to-market method of accounting for your securities holdings;

a tax-exempt organization;

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an insurance company;

a person liable for alternative minimum tax;

a person that actually or constructively owns 10% or more of our voting stock;

a person that holds H shares or ADSs that are a hedge or that are hedged against currency risks or as part of a straddle or a conversion transaction; or

a U.S. holder (as defined below) whose functional currency is not the U.S. dollar.

This section is based on the Internal Revenue Code of 1986, as amended, its legislative history, existing and proposed regulations, published rulings and court decisions, all as currently in effect. These laws are subject to change, possibly on a retroactive basis. In addition, this section is based in part upon the representations of the Depositary and the assumption that each obligation in the deposit agreement and any related agreement will be performed in accordance with its terms.

You are a U.S. holder if you are a beneficial owner of H shares or ADSs and you are:

a citizen or resident of the United States;

a domestic corporation;

an estate whose income is subject to United States federal income tax regardless of its source; or

a trust if a United States court can exercise primary supervision over the trust's administration and one or more United States persons are authorized to control all substantial decisions of the trust.

You should consult your own tax advisor regarding the United States federal, state and local tax consequences of owning and disposing of H shares and ADSs in your particular circumstances.

This discussion addresses only United States federal income taxation.

In general, and taking into account the earlier assumptions, for United States federal income tax purposes, if you hold ADRs evidencing ADSs, you will be treated as the owner of H shares represented by those ADSs. Exchanges of H shares for ADSs, and ADSs for H shares, generally will not be subject to United States federal income tax.

*Taxation of Dividends*

Under the United States federal income tax laws, and subject to the passive foreign investment company, or PFIC, rules discussed below, if you are a U.S. holder, you must include in your gross income the gross amount of any dividend paid by us out of our current or accumulated earnings and profits (as determined for United States federal income tax purposes). If you are a noncorporate U.S. holder, dividends paid to you in taxable years beginning before January 1, 2009 that constitute qualified dividend income will be taxable to you at a maximum rate of 15% provided that you hold H shares or ADSs for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date and meet other holding period requirements. Dividends we pay with respect to H shares or ADSs generally will be qualified dividend income. You must include any Chinese tax withheld from the dividend payment in this gross amount even though you do not in fact receive it. You must include the dividend in income when you, in the case of H shares, or the depository, in the case of ADSs, receive the dividend, actually or constructively. The dividend will not be eligible for the dividends-received deduction generally allowed to United States corporations in respect of dividends received from other United States corporations.

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The amount of the dividend distribution that you must include in your income as a U.S. holder will be the U.S. dollar value of the Hong Kong Dollar payments made, determined at the Hong Kong dollar/U.S. dollar spot rate on the date the dividend distribution is includible in your income, regardless of whether the payment is in fact converted into U.S. dollars. Generally, any gain or loss resulting from currency exchange fluctuations during the period from the date you include the dividend payment in income to the date you convert the payment into U.S. dollars will be treated as ordinary income or loss. The gain or loss generally will be income from sources within the United States for foreign tax credit limitation purposes. Distributions in excess of current and accumulated earnings and profits, as determined for United States federal income tax purposes, will be treated as a non-taxable return of capital to the extent of your basis in the H shares or ADSs and thereafter as capital gain.

Dividends will be income from sources outside the United States, but dividends paid in taxable years beginning before January 1, 2007 generally will be passive income or financial services income, and dividends paid in taxable years beginning after December 31, 2006, will, depending on your circumstances, be passive income or general income, which, in either case, is treated separately from other types of income for purposes of computing the foreign tax credit allowable to you.

### ***Taxation of Capital Gains***

Subject to the PFIC rules discussed below, if you are a U.S. holder and you sell or otherwise dispose of your H shares or ADSs, you will recognize capital gain or loss for United States federal income tax purposes equal to the difference between the U.S. dollar value of the amount that you realize and your tax basis, determined in U.S. dollars, in your H shares or ADSs. Capital gain of a noncorporate U.S. holder that is recognized before January 1, 2009 is generally taxed at a maximum rate of 15% where the holder has a holding period greater than one year. The gain or loss will generally be income or loss from sources within the United States for foreign tax credit limitation purposes. Your ability to deduct capital losses is subject to limitations.

### ***Hong Kong Stamp Duty***

Any Hong Kong stamp duty that you pay will not be a creditable tax for United States federal income tax purposes, but you may be able to deduct such stamp duty subject to limitations under the Code.

**PFIC Rules.** We believe that H shares and ADSs should not be treated as stock of a PFIC for United States federal income tax purposes, but this conclusion is a factual determination that is made annually and thus may be subject to change. If we were to be treated as a PFIC, unless a U.S. holder elects to be taxed annually on a mark-to-market basis with respect to the H shares or ADSs, gain realized on the sale or other disposition of your H shares or ADSs would in general not be treated as capital gain. Instead, if you are a U.S. holder, you would be treated as if you had realized such gain and certain excess distributions ratably over your holding period for the H shares or ADSs and would be taxed at the highest tax rate in effect for each such year to which the gain was allocated, together with an interest charge in respect of the tax attributable to each such year. With certain exceptions, your H shares or ADSs will be treated as stock in a PFIC if we were a PFIC at any time during your holding period in your H shares or ADSs. Dividends that you receive from us will not be eligible for the special tax rates applicable to qualified dividend income if we are treated as a PFIC with respect to you either in the taxable year of the distribution or the preceding taxable year, but instead will be taxable at rates applicable to ordinary income.

### **F. Dividends and Paying Agents.**



Not applicable.

**G. Statement by Experts.**

Not applicable.

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### **H. Documents on Display**

You may read and copy documents referred to in this annual report on Form 20-F that have been filed with the U.S. Securities and Exchange Commission at the SEC's public reference room located at 450 Fifth Street, NW, Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the public reference rooms and their copy charges. The SEC also maintains a web site at <http://www.sec.gov> that contains reports, proxy statements and other information regarding registrants that file electronically with the SEC.

The SEC allows us to incorporate by reference the information we file with the SEC. This means that we can disclose important information to you by referring you to another document filed separately with the SEC. The information incorporated by reference is considered to be part of this annual report on Form 20-F.

### **I. Subsidiary Information**

Not applicable.

### **J. Summary of Significant Differences between the Corporate Governance Practices of the Company and Those Followed by Domestic Companies under NYSE Listing Standards**

As a company incorporated in the PRC and listed on the Stock Exchange of Hong Kong Limited, or the HKSE, and the New York Stock Exchange, or the NYSE, our company, as a foreign private issuer, is not required to comply with all of the corporate governance rules of Section 303A of the NYSE Listed Company Manual, but should disclose the significant ways in which our corporate governance practices differ from those followed by domestic companies under NYSE listing standards.

Under the NYSE corporate governance rule 303A.01, a listed company must have a majority of independent directors on its board of directors. A company of which more than 50% of the voting power is held by an individual, a group or another company is not required to comply with this requirement. Because approximately 72% of our voting power is controlled by China Telecom Group, we, as a controlled company, would not be required to comply with the majority of independent directors requirement.

In addition, under currently applicable PRC or Hong Kong laws and regulations, we are not required to have a board with a majority of independent directors. As a company listed on the HKSE, we are subject to the requirement of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited, or the Hong Kong Listing Rules, that at least three members of our board of directors be independent as determined thereunder. We currently have three independent directors out of a total of fifteen directors, who satisfy both the requirements regarding independence of the Hong Kong Listing Rules and Section 303A.02 of the NYSE Listed Company Manual.

Currently, we do not have a nomination/corporate governance committee and are not required to do so under currently applicable PRC or Hong Kong laws and regulations.

All members of our audit committee have extensive management experience. However, they do not possess direct experience or expertise in respect of the reconciliation of financial statements with U.S. GAAP and the evaluation of reports filed with the U.S. Securities and Exchange Commission, or the SEC, by SEC-reporting issuers. Our audit committee is in the process of considering appointing, from time to time, an external financial expert as a consultant.

We have not adopted a separate set of corporate governance guidelines and are not required to do so under currently applicable PRC or Hong Kong laws and regulations. However, we are in compliance with the Code on Corporate Governance Practices promulgated by the HKSE.

**Item 11. Quantitative and Qualitative Disclosures about Market Risk.**

Our primary market risk exposures are fluctuations in exchange rates and interest rates.

**Table of Contents****Foreign Exchange Rate Risk**

We conduct our business primarily in Renminbi, which is also our functional and reporting currency. The Renminbi is not a fully-convertible currency. Although the Renminbi to United States dollar exchange rate has been relatively stable since 1994, we cannot predict nor give any assurance of its future stability. Fluctuations in exchange rates may adversely affect the value, translated or converted into United States dollars or Hong Kong dollars, of our net assets, earnings and any declared dividends. We cannot give any assurance that any future movements in the exchange rate of the Renminbi against the United States dollar or other foreign currencies will not adversely affect our results of operations and financial condition. See Item 3. Key Information D. Risk Factors Risks Relating to the People's Republic of China Government control of currency conversion may adversely affect our operations and financial results; Fluctuation of the Renminbi could materially affect our financial condition and results of operations.

The following tables provide information regarding our financial instruments that are sensitive to foreign exchange rates as of December 31, 2003 and 2004, respectively. For debt obligations, the tables present principal cash flows and related weighted average interest rates by expected maturity dates.

**As of December 31, 2004:**

	Expected Maturity						Total	Fair Value
	2005	2006	2007	2008	2009	Thereafter		
(RMB equivalent in millions, except interest rates)								
<b>Assets:</b>								
Cash and cash equivalents								
United States dollars	105						105	105
Japanese yen	1						1	1
Time deposits								
United States dollars	221						221	221
<b>Liabilities:</b>								
Debts in Japanese yen								
Fixed rate	333	552	674	355	104	1,164	3,182	3,318
Average interest rate	1.2%	1.2%	1.7%	1.2%	2.8%	2.7%		
Debts in United States dollars								
Fixed rate	584	363	121	70	67	999	2,204	2,133
Average interest rate	3.6%	2.8%	2.3%	2.1%	2.0%	1.5%		
Variable rate	152	368	130	29			679	655
Average interest rate <sup>(1)</sup>	1.2%	2.7%	1.4%	0.5%				
Debts in Euro								
Fixed rate	66	42	42	42	42	819	1,053	1,006
Average interest rate	4.5%	2.6%	2.6%	2.6%	2.6%	1.9%		
Debts in other currencies								
Variable rate	3	6	6	6	5	44	70	68
Average interest rate <sup>(1)</sup>	2.1%	2.1%	2.1%	2.1%	2.1%	3.0%		

(1) The average interest rates for variable rate debts are calculated based on the rates reported as of December 31, 2004.



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As of December 31, 2003:

	Expected Maturity						Total	Fair Value
	2004	2005	2006	2007	2008	Thereafter		
(RMB equivalent in millions, except interest rates)								
<b>Assets:</b>								
Cash and cash equivalents								
United States dollars	266						266	266
Hong Kong dollars	1						1	1
Time deposits								
United States dollars	227						227	227
Hong Kong dollars	21						21	21
<b>Liabilities:</b>								
Debts in Japanese yen								
Fixed rate	429	432	418	384	386	2,131	4,180	4,413
Average interest rate	1.2%	1.2%	1.3%	1.3%	1.4%	2.5%		
Debts in United States dollars								
Fixed rate	855	694	442	130	63	1,102	3,286	3,320
Average interest rate	3.9%	4.1%	3.5%	3.6%	3.5%	2.7%		
Variable rate	63	162	347	58	29		659	660
Average interest rate <sup>(1)</sup>	1.9%	3.0%	2.6%	1.8%	1.8%			
Debts in Euro								
Fixed rate	59	135	43	40	40	722	1,039	1,040
Average interest rate	3.9%	3.9%	3.6%	3.2%	3.1%	2.3%		
Debts in other currencies								
Variable rate	1	7	7	7	5	46	73	74
Average interest rate <sup>(1)</sup>	2.1%	3.2%	2.9%	3.2%	2.8%	3.0%		

(1) The average interest rates for variable rate debts are calculated based on the rates reported as of December 31, 2003.

**Interest Rate Risk**

The People's Bank of China has the sole authority in China to establish the official interest rates for Renminbi-denominated loans. Financial institutions in China set their effective interest rates within the range established by the People's Bank of China. Interest rates and payment methods on loans denominated in foreign currencies are set by financial institutions based on interest rate changes in the international financial market, cost of funds, risk levels and other factors.

We are exposed to interest rate risk resulting from fluctuations in interest rates on our short-term and long-term debts. Increases in interest rates will increase the cost of new borrowing and the interest expense with respect to outstanding floating rate debt. As of December 31, 2003 and 2004, our debt consisted of fixed and variable rate debt obligations with maturities from 2005 to 2040 and from 2004 to 2040, respectively.

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The following tables present cash flows and related weighted average interest rates by expected maturity dates of our interest rate sensitive financial instruments as of December 31, 2003 and 2004, respectively:

**As of December 31, 2004:**

	Expected Maturity						Total	Fair Value
	2005	2006	2007	2008	2009	Thereafter		
(RMB equivalent in millions, except interest rates)								
<b>Liabilities:</b>								
Debts in Renminbi								
Fixed rate	8,604	6,591	6,350			5	21,550	21,410
Average interest rate	5.3%	5.0%	5.0%			5.3%		
Variable rate	68,076	2,100	1,200	50	50	50,150	121,446	120,236
Average interest rate <sup>(1)</sup>	4.4%	5.1%	5.0%	5.2%	5.2%	5.2%		
Debts in Japanese yen								
Fixed rate	333	552	674	355	104	1,164	3,182	3,318
Average interest rate	1.2%	1.2%	1.7%	1.2%	2.8%	2.7%		
Debts in United States dollars								
Fixed rate	584	363	121	70	67	999	2,204	2,133
Average interest rate	3.6%	2.8%	2.3%	2.1%	2.0%	1.5%		
Variable rate	152	368	130	29			679	655
Average interest rate <sup>(1)</sup>	1.2%	2.7%	1.4%	0.5%				
Debts in Euro								
Fixed rate	66	42	42	42	42	819	1,053	1,006
Average interest rate	4.5%	2.6%	2.6%	2.6%	2.6%	1.9%		
Debts in other currencies								
Variable rate	3	6	6	6	5	44	70	68
Average interest rate <sup>(1)</sup>	2.1%	2.1%	2.1%	2.1%	2.1%	3.0%		

(1) The average interest rates for variable rate debts are calculated based on the rates reported as of December 31, 2004.

**As of December 31, 2003:**

	Expected Maturity						Total	Fair Value
	2004	2005	2006	2007	2008	Thereafter		
(RMB equivalent in millions, except interest rates)								
<b>Liabilities:</b>								
Debts in Renminbi								
Fixed rate	5,812	9,356	5,696	1,645	150	4	22,663	22,792
Average interest rate	5.4%	5.2%	5.1%	5.3%	5.2%	5.9%		
Variable rate	62,981	4,672	3,578	600	50	35,051	106,932	107,014
Average interest rate <sup>(1)</sup>	4.7%	5.2%	5.1%	5.2%	5.2%	5.2%		





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	Expected Maturity						Total	Fair Value
	2004	2005	2006	2007	2008	Thereafter		
(RMB equivalent in millions, except interest rates)								
Debts in Japanese yen								
Fixed rate	429	432	418	384	386	2,131	4,180	4,413
<i>Average interest rate</i>	1.2%	1.2%	1.3%	1.3%	1.4%	2.5%		
Debts in United States dollars								
Fixed rate	855	694	442	130	63	1,102	3,286	3,320
<i>Average interest rate</i>	3.9%	4.1%	3.5%	3.6%	3.5%	2.7%		
Variable rate	63	162	347	58	29		659	660
<i>Average interest rate<sup>(1)</sup></i>	1.9%	3.0%	2.6%	1.8%	1.8%			
Debts in Euro								
Fixed rate	59	135	43	40	40	722	1,039	1,040
<i>Average interest rate</i>	3.9%	3.9%	3.6%	3.2%	3.1%	2.3%		
Debts in other currencies								
Variable rate	1	7	7	7	5	46	73	74
<i>Average interest rate<sup>(1)</sup></i>	2.1%	3.2%	2.9%	3.2%	2.8%	3.0%		

(1) The average interest rates for variable rate debts are calculated based on the rates reported as of December 31, 2003.

**Item 12. Description of Securities Other than Equity Securities.**

Not applicable.

**PART II****Item 13. Defaults, Dividend Arrearages and Delinquencies.**

None.

**Item 14. Material Modifications to the Rights of Security Holders and Use of Proceeds.*****Material Modifications to the Rights of Security Holders***

None.

*Use of Proceeds*

The following use of proceeds information relates to our registration statement on Form F-1 (File No. 333-100042), filed by us in connection with our initial public offering. Our H shares commenced trading on the Hong Kong Stock Exchange on November 15, 2002. China International Capital Corporation Limited, Merrill Lynch, Pierce, Fenner & Smith Incorporated and Morgan Stanley & Co. Incorporated acted as U.S. representatives for the U.S. underwriters and China International Capital Corporation Limited, Merrill Lynch International and Morgan Stanley & Co. International Limited acted as international representatives for the international underwriters.

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The following table sets forth for China Telecom as the issuer and each selling shareholder information regarding our H shares registered and sold in our initial public offering, including the exercise of the over-allotment option:

	<b>Amount Registered and Sold</b>	<b>Aggregate Price of the Amount Registered and Sold to Date (US\$)</b>
China Telecom	7,296,915,700	1,383,854,526.34
China Telecom Group	635,623,200	120,588,923.33
Guangdong Rising Assets Management Co., Ltd.	61,159,700	11,603,072.98
Jiangsu Guoxin Investment Group Co., Ltd.	10,425,800	1,977,958.01
Zhejiang Financial Development Company	23,285,600	4,417,688.71
<b>Total</b>	<b>8,027,410,000</b>	<b>1,522,442,169.37</b>

The amount of expenses incurred by us in connection with the issuance and distribution of the registered securities totaled USD96,100,213.3, including USD42,539,632.8 for underwriting discounts and commissions, and approximately USD53,560,580.5 for other expenses. None of the payments were direct or indirect payments to our directors, officers, general partners of our associates, persons owning 10% or more of any class of our shares, or any of our affiliates.

The net proceeds from the initial public offering of our shares, after deduction of fees and expenses, amounted to RMB10,659 million. In 2003, RMB3197.7 million (equivalent to USD386.3 million) was used for the acquisition of telecommunications assets from China Telecom Group in 2003. The remaining proceeds were used for the expansion and upgrading of our telecommunications network infrastructure, the improvement of our business operation supporting systems, the development of telecommunications applications and technologies, and for general corporate purposes. No application of our net offering proceeds represented direct or indirect payments to our directors, officers, general partners of our associates, persons owning 10% or more of any class of our shares, or any of our affiliates.

**Item 15. Controls and Procedures.***Disclosure Controls and Procedures*

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) of the Securities Exchange Act of 1934) as of the end of the fiscal year covered by this annual report. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the fiscal year covered by this annual report, our disclosure controls and procedures were adequate and effective to ensure that material information relating to our company, including our consolidated subsidiaries, was made known to them by others within our company and our consolidated subsidiaries.

**Item 16A. Audit Committee Financial Expert.**

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All members of our audit committee have extensive management experience. However, members of our audit committee do not possess direct experience or expertise in respect of the reconciliation of financial statements with U.S. GAAP and the evaluation of reports filed with the U.S. Securities and Exchange Commission by SEC-reporting issuers. Our board of directors has determined that we do not currently have an audit committee financial expert, as defined in Item 16A(b) of Form 20-F, serving on our audit committee. Our audit committee is in the process of considering appointing, from time to time, an external financial expert as a consultant.

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**Table of Contents****Item16B. Code of Ethics.**

We have adopted a code of ethics that applies to our chief executive officer, chief financial officer, controller and other senior officers of our company. We have filed this code of ethics as an exhibit to our annual report for the fiscal year ended December 31, 2003 and we hereby incorporate that exhibit into this annual report.

**Item16C. Principal Accountant Fees and Services.**

The following table sets forth the aggregate audit fees, audit-related fees, tax fees of our principal accountants and all other fees billed for products and services provided by our principal accountants other than the audit fees, audit-related fees and tax fees for each of the fiscal years 2003 and 2004:

	<u>Audit Fees</u>	<u>Audit-Related Fees</u>	<u>Tax Fees</u>	<u>Other Fees</u>
2003	RMB107 million	RMB2 million		
2004	RMB129 million	RMB14 million		

Before our principal accountants were engaged by our company or our subsidiaries to render audit or non-audit services, the engagement has been approved by our audit committee.

**Item16D. Exemptions from the Listing Standards for Audit Committees.**

Not applicable.

**Item16E. Purchases of Equity Securities by the Issuer and Affiliated Purchasers.**

None.

**PART III****Item 17. Financial Statements.**

We have elected to provide the financial statements and related information specified in Item 18 in lieu of Item 17.

**Item 18. Financial Statements.**

See Index to Financial Statements for a list of all financial statements filed as part of this annual report.

**Item 19. Exhibits.**

(a) See Item 18 for a list of the financial statements filed as part of this annual report.

(b) Exhibits to this annual report:

**Exhibit Index**

<b>Exhibits</b>	<b>Description</b>
1.1	Articles of Association (as amended) (English translation).
2.1	Form of H Share Certificate. <sup>(1)</sup>

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<b>Exhibits</b>	<b>Description</b>
2.2	Form of Deposit Agreement among the Registrant, The Bank of New York, as depository, and Owners and Beneficial Owners from time to time of American Depositary Shares evidenced by American Depositary Receipts issued thereunder, including the form of American Depositary Receipt. <sup>(2)</sup>
4.1	Supplemental Trademark License Agreement, dated October 26, 2003, between the Registrant and China Telecom Group (English translation). <sup>(3)</sup>
4.2	Sale and Purchase Agreement, dated October 26, 2003, between the Registrant and China Telecom Group (English translation). <sup>(3)</sup>
4.3	Supplemental Connected Transactions Agreement, dated October 26, 2003, between the Registrant and China Telecom Group (English translation). <sup>(3)</sup>
4.4	Form of Underwriting Agreement. <sup>(4)</sup>
4.5	Supplemental Trademark License Agreement, dated April 13, 2004, between the Registrant and China Telecom Group (English translation). <sup>(5)</sup>
4.6	Supplemental Connected Transactions Agreement, dated April 13, 2004, between the Registrant and China Telecom Group (English translation). <sup>(6)</sup>
4.7	Comprehensive Services Agreement, dated April 13, 2004, between the Registrant and China Telecom Group (English translation). <sup>(7)</sup>
4.8	Conditional Sale and Purchase Agreement, dated April 13, 2004, between the Registrant and China Telecom Group (English translation). <sup>(8)</sup>
4.9	Supplemental Conditional Sale and Purchase Agreement, dated June 9, 2005, between the Registrant and China Telecom Group (English summary)
8.1	List of subsidiaries of the Registrant.
11.1	Code of Ethics (English translation). <sup>(3)</sup>
12.1	Certification of CEO pursuant to Rule 13a-14(a).
12.2	Certification of CFO pursuant to Rule 13a-14(a).
13.1	Certification of CEO pursuant to Rule 13a-14(b).
13.2	Certification of CFO pursuant to Rule 13a-14(b).
14.1	Consent of KPMG.

- (1) Incorporated by reference to our Registration Statement on Form F-1 (File No. 333-100042), filed with the Securities and Exchange Commission on November 5, 2002.
- (2) Incorporated by reference to our Registration Statement on Form F-6 (File No. 333-100617), filed with the Securities and Exchange Commission with respect to American Depositary Shares representing our H shares.
- (3) Incorporated by reference to our Annual Report on Form 20-F for the fiscal year ended December 31, 2003 (File No. 001-31517), filed with the Securities and Exchange Commission.
- (4) Incorporated by reference to Exhibit 1.1 to our Form 6-K filed on April 29, 2004

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- (5) Incorporated by reference to Exhibit 1.2 to our Form 6-K filed on April 29, 2004.
- (6) Incorporated by reference to Exhibit 1.3 to our Form 6-K filed on April 29, 2004.
- (7) Incorporated by reference to Exhibit 1.4 to our Form 6-K filed on April 29, 2004.
- (8) Incorporated by reference to Exhibit 1.5 to our Form 6-K filed on April 29, 2004.



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**SIGNATURES**

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

**CHINA TELECOM CORPORATION LIMITED**

By:           /s/ Wang Xiaochu          

Name: Wang Xiaochu

Title: Chairman and Chief Executive Officer

Date: May 24, 2005

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**CHINA TELECOM CORPORATION LIMITED AND SUBSIDIARIES**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**The Board of Directors and Shareholders of**

**China Telecom Corporation Limited:**

We have audited the accompanying consolidated balance sheets of China Telecom Corporation Limited and subsidiaries (the Group) as of December 31, 2003 and 2004, and the related consolidated statements of income, shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2004, all expressed in Renminbi. These consolidated financial statements are the responsibility of the Group's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States) and auditing standards generally accepted in Hong Kong. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Group as of December 31, 2003 and 2004, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2004, in conformity with International Financial Reporting Standards promulgated by the International Accounting Standards Board.

International Financial Reporting Standards vary in certain significant respects from accounting principles generally accepted in the United States of America. Information relating to the nature and effect of such differences is presented in Note 33 to the consolidated financial statements.

The accompanying consolidated financial statements as of and for the year ended December 31, 2004 have been translated into United States dollars solely for the convenience of the reader. We have audited the translation and, in our opinion, the consolidated financial statements expressed in Renminbi have been translated into United States dollars on the basis set forth in Note 2(a) to the consolidated financial statements.

KPMG

Hong Kong, China

March 31, 2005



**Table of Contents****CHINA TELECOM CORPORATION LIMITED AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

AS OF DECEMBER 31, 2003 AND 2004

(Amounts in millions)

	Note	December 31,		
		2003	2004	2004
		RMB	RMB	US\$
<b>ASSETS</b>				
<b>Current assets</b>				
Cash and cash equivalents	3	12,721	13,465	1,627
Time deposits with maturity over three months		473	315	38
Accounts receivable, net	4	12,951	13,921	1,682
Inventories	5	3,253	2,767	334
Prepayments and other current assets	6	3,695	3,064	370
<b>Total current assets</b>		<b>33,093</b>	<b>33,532</b>	<b>4,051</b>
<b>Non-current assets</b>				
Property, plant and equipment, net	7	309,896	320,179	38,685
Construction in progress	8	31,617	29,450	3,558
Lease prepayments		4,485	4,830	584
Interests in associates	9	513	511	62
Investments	10	206	200	24
Deferred tax assets	11	10,523	10,805	1,306
Other assets	16	13,609	13,063	1,578
<b>Total non-current assets</b>		<b>370,849</b>	<b>379,038</b>	<b>45,797</b>
<b>Total assets</b>		<b>403,942</b>	<b>412,570</b>	<b>49,848</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>				
<b>Current liabilities</b>				
Short-term debt	12	56,243	65,976	7,971
Current portion of long-term debt	12	13,957	11,842	1,431
Accounts payable	13	35,629	33,658	4,067
Accrued expenses and other payables	14	26,004	27,531	3,326
Income tax payable		3,395	1,192	144
Current portion of finance lease obligations	15	50	156	19
Current portion of deferred revenues	16	13,857	11,589	1,400
<b>Total current liabilities</b>		<b>149,135</b>	<b>151,944</b>	<b>18,358</b>
<b>Non-current liabilities</b>				
Long-term debt	12	68,632	72,366	8,743
Finance lease obligations	15	43	157	19
Deferred revenues	16	32,744	25,182	3,043
Deferred tax liabilities	11	1,325	2,302	278
<b>Total non-current liabilities</b>		<b>102,744</b>	<b>100,007</b>	<b>12,083</b>

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<b>Total liabilities</b>		251,879	251,951	30,441
<b>Minority interests</b>		1,269	1,413	171
<b>Shareholders' equity</b>				
Share capital	<b>17</b>	75,614	80,932	9,779
Reserves	<b>18</b>	75,180	78,274	9,457
<b>Total shareholders' equity</b>		<u>150,794</u>	<u>159,206</u>	<u>19,236</u>
<b>Total liabilities and shareholders' equity</b>		<u>403,942</u>	<u>412,570</u>	<u>49,848</u>

See accompanying notes to consolidated financial statements.

**Table of Contents****CHINA TELECOM CORPORATION LIMITED AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME**

FOR THE YEARS ENDED DECEMBER 31, 2002, 2003 AND 2004

(Amounts in millions, except per share data)

	Note	Year ended December 31,			
		2002	2003	2004	2004
		RMB	RMB	RMB	US\$
<b>Operating revenues</b>	<b>19</b>	140,906	151,553	161,212	19,478
<b>Operating expenses</b>					
Depreciation and amortization		(45,810)	(46,597)	(47,170)	(5,699)
Network operations and support		(46,215)	(44,118)	(43,070)	(5,204)
Selling, general and administrative		(20,585)	(24,810)	(27,003)	(3,262)
Other operating expenses	<b>20</b>	(3,188)	(3,176)	(4,139)	(500)
<b>Total operating expenses</b>	<b>21</b>	(115,798)	(118,701)	(121,382)	(14,665)
<b>Operating income</b>		25,108	32,852	39,830	4,813
Deficit on revaluation of property, plant and equipment	<b>7</b>	(14,690)	(14,832)	(1,262)	(153)
Net finance costs	<b>22</b>	(4,071)	(3,606)	(5,340)	(645)
Investment income/(loss)		50	(42)	6	1
Equity in income of associates		38	35	29	3
<b>Income before income tax and minority interests</b>		6,435	14,407	33,263	4,019
Income tax	<b>23</b>	1,856	(469)	(5,187)	(627)
<b>Income before minority interests</b>		8,291	13,938	28,076	3,392
Minority interests		(72)	(56)	(53)	(6)
<b>Net income</b>		8,219	13,882	28,023	3,386
<b>Basic earnings per share</b>	<b>25</b>	0.12	0.18	0.36	0.04
<b>Weighted average number of shares</b>	<b>25</b>	69,242	75,614	78,840	78,840

See accompanying notes to consolidated financial statements.

**Table of Contents****CHINA TELECOM CORPORATION LIMITED AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY**

FOR THE YEARS ENDED DECEMBER 31, 2002, 2003 AND 2004

(Amounts in millions)

	Note	Share capital	Capital reserve	Share premium	Revaluation reserve	Surplus reserves	Statutory common welfare fund	Other reserves	Retained earnings	Total shareholders equity
		RMB	RMB	RMB	RMB	RMB	RMB	RMB	RMB	RMB
Balance as of January 1, 2002, as previously reported					4,154			41,730	89,272	135,156
Adjusted for the Second Acquisition	<b>1</b>							34,316		34,316
Balance as of January 1, 2002, as adjusted					4,154			76,046	89,272	169,472
Capitalization as share capital upon incorporation of the Company		68,317	20,955						(89,272)	
Issue of shares, net of issuing expenses of RMB796		7,297		3,362						10,659
Net income									8,219	8,219
Contributions from China Telecom									4,438	4,438
Distributions to China Telecom									(3,762)	(3,762)
Assets distributed to China Telecom in connection with the First Acquisition	<b>1</b>								(5,189)	(5,189)
Revaluation surplus	<b>7</b>				760					760
Recognition of deferred tax assets	<b>11</b>							2,408		2,408
Elimination of deferred tax liabilities	<b>11</b>								20	20
Transfer from retained earnings to other reserves								(13,138)	13,138	
Appropriations	<b>18</b>					8,121	1,624		(9,745)	
Revaluation surplus realized					(10)				10	
Deferred tax on land use rights realized								(75)	75	
Balance as of December 31, 2002		75,614	20,955	3,362	4,904	8,121	1,624	65,241	7,204	187,025
Net income									13,882	13,882
Contributions from China Telecom									4,309	4,309
Distributions to China Telecom									(1,234)	(1,234)
Assets distributed to China Telecom in connection with the Second Acquisition	<b>1</b>								(10,762)	(10,762)
Revaluation surplus	<b>7</b>				1,537					1,537
Recognition of deferred tax assets	<b>11</b>							2,209		2,209
Elimination of deferred tax liabilities	<b>11</b>								150	150
Transfer from retained earnings to other reserves								(11,812)	11,812	
Consideration for the acquisition of the First Acquired Group	<b>1</b>							(45,649)		(45,649)
Transfer from other reserves to capital reserve			(14,388)					14,388		



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Appropriations	<b>18</b>				7,340	1,748		(9,088)	
Dividends								(673)	(673)
Revaluation surplus realized				(17)				17	
Deferred tax on land use rights realized							(131)	131	
Balance as of December 31, 2003	75,614	6,567	3,362	6,424	15,461	3,372	24,246	15,748	150,794

See accompanying notes to consolidated financial statements.

**Table of Contents****CHINA TELECOM CORPORATION LIMITED AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY (CONTINUED)**

FOR THE YEARS ENDED DECEMBER 31, 2002, 2003 AND 2004

(Amounts in millions)

	Note	Share capital	Capital reserve	Share premium	Revaluation reserve	Surplus reserves	Statutory common welfare fund	Other reserves	Retained earnings	Total shareholders equity
		RMB	RMB	RMB	RMB	RMB	RMB	RMB	RMB	RMB
Balance as of December 31, 2003		75,614	6,567	3,362	6,424	15,461	3,372	24,246	15,748	150,794
Issue of shares, net of issuing expenses of RMB294		5,318		7,384						12,702
Net income									28,023	28,023
Contributions from China Telecom									100	100
Transfer from retained earnings to other reserves								2,653	(2,653)	
Consideration for the acquisition of the Second Acquired Group	1							(27,800)		(27,800)
Transfer from other reserves to capital reserve			(9,371)					9,371		
Revaluation surplus	7				1,233					1,233
Deferred tax on revaluation surplus of property, plant and equipment	11							(378)		(378)
Appropriations	18					10,168	2,421		(12,589)	
Dividends	24								(5,224)	(5,224)
Effect of change in tax rate	11							(244)		(244)
Revaluation surplus realized					(72)				72	
Deferred tax on land use rights realized								(165)	165	
Balance as of December 31, 2004		80,932	(2,804)	10,746	7,585	25,629	5,793	7,683	23,642	159,206
Balance as of December 31, 2004 (in US\$)		9,779	(339)	1,298	916	3,097	700	928	2,857	19,236

See accompanying notes to consolidated financial statements.

**Table of Contents****CHINA TELECOM CORPORATION LIMITED AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS**

FOR THE YEARS ENDED DECEMBER 31, 2002, 2003 AND 2004

(Amounts in millions)

	Note	Year ended December 31,			
		2002	2003	2004	2004
		RMB	RMB	RMB	US\$
<b>Cash flows from operating activities</b>	(a)	62,357	58,392	66,078	7,984
<b>Cash flows from investing activities</b>					
Capital expenditure		(61,437)	(57,692)	(56,446)	(6,820)
Purchase of investments		(332)	(485)	(42)	(5)
Lease prepayments		(500)	(355)	(444)	(53)
Proceeds from disposal of investments			52	42	5
Proceeds from disposal of property, plant and equipment		483	348	379	45
Purchase of time deposits with maturity over three months		(1,489)	(466)	(325)	(39)
Maturity of time deposits with maturity over three months		697	1,504	483	58
<b>Net cash used in investing activities</b>		(62,578)	(57,094)	(56,353)	(6,809)
<b>Cash flows from financing activities</b>					
Proceeds from initial public offering, net of issuing expenses		10,659			
Proceeds from issue of shares, net of issuing expenses				12,702	1,535
Capital element of finance lease payments		(715)	(210)	(50)	(6)
Proceeds from bank and other debt		86,975	83,472	77,120	9,318
Repayments of bank and other debt		(89,023)	(86,147)	(81,070)	(9,795)
Payment of dividends			(673)	(5,224)	(631)
Cash (distributions to) / contributions from minority interests		(14)	(27)	91	11
Cash payment for the acquisition of the First Acquired Group			(11,000)		
Cash payment for the acquisition of the Second Acquired Group				(12,650)	(1,529)
Cash contributions from China Telecom		4,226	3,461	100	12
Cash distributions to China Telecom		(4,418)	(196)		
<b>Net cash from/(used in) financing activities</b>		7,690	(11,320)	(8,981)	(1,085)
<b>Net increase/(decrease) in cash and cash equivalents</b>		7,469	(10,022)	744	90
<b>Cash and cash equivalents at beginning of year</b>		15,274	22,743	12,721	1,537
<b>Cash and cash equivalents at end of year</b>		22,743	12,721	13,465	1,627

See accompanying notes to consolidated financial statements.



**Table of Contents****CHINA TELECOM CORPORATION LIMITED AND SUBSIDIARIES****NOTES TO CONSOLIDATED STATEMENTS OF CASH FLOWS**

FOR THE YEARS ENDED DECEMBER 31, 2002, 2003 AND 2004

(Amounts in millions)

**(a) Reconciliation of income before income tax and minority interests to cash flows from operating activities**

	Year ended December 31,			
	2002	2003	2004	2004
	RMB	RMB	RMB	US\$
<b>Income before income tax and minority interests</b>	6,435	14,407	33,263	4,019
Adjustments for:				
Depreciation and amortization	45,810	46,597	47,170	5,699
Deficit on revaluation of property, plant and equipment	14,690	14,832	1,262	153
Provision for doubtful accounts	1,004	1,037	1,121	136
Investment (income)/loss	(50)	42	(6)	(1)
Equity in income of associates	(38)	(35)	(29)	(3)
Interest income	(248)	(331)	(231)	(28)
Interest expense	3,826	3,340	5,367	648
Unrealized foreign exchange losses	449	495	152	18
Loss on retirement and disposal of property, plant and equipment and impairment loss	3,753	1,628	961	116
Increase in accounts receivable	(1,535)	(2,383)	(2,091)	(253)
Decrease/(increase) in inventories	742	(687)	486	59
Decrease in prepayments and other current assets	2,311	116	481	58
(Increase)/decrease in other non-current assets	(1,104)	12	297	36
Increase/(decrease) in accounts payable	235	(335)	55	7
Increase in accrued expenses and other payables	786	34	1,517	183
Decrease in deferred revenues	(8,850)	(9,320)	(9,830)	(1,188)
<b>Cash generated from operations</b>	68,216	69,449	79,945	9,659
Interest received	248	331	231	28
Interest paid	(5,533)	(4,944)	(6,824)	(824)
Investment income received	92	17	43	5
Income tax paid	(666)	(6,461)	(7,317)	(884)
<b>Cash flows from operating activities</b>	62,357	58,392	66,078	7,984

See accompanying notes to consolidated financial statements.

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### **CHINA TELECOM CORPORATION LIMITED AND SUBSIDIARIES**

#### **NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

(All amounts in millions, except per share data)

#### **1. PRINCIPAL ACTIVITIES, ORGANIZATION AND BASIS OF PRESENTATION**

##### **Principal activities**

China Telecom Corporation Limited (the Company) and its subsidiaries (hereinafter, collectively referred to as the Group) are engaged in the provision of wireline telecommunications and related services in Shanghai Municipality, Guangdong Province, Jiangsu Province, Zhejiang Province, Anhui Province, Fujian Province, Jiangxi Province, Guangxi Zhuang Autonomous Region, Chongqing Municipality, Sichuan Province, Hubei Province, Hunan Province, Hainan Province, Guizhou Province, Yunnan Province, Shaanxi Province, Gansu Province, Qinghai Province, Ningxia Hui Autonomous Region and Xinjiang Uygur Autonomous Region of the People's Republic of China (the PRC). The Group offers a comprehensive range of wireline telecommunications services to residential and business customers, including local, domestic long distance (DLD) and international long distance (ILD) telephone services, Internet and managed data, leased line, and other related services.

The operations of the Group are subject to the supervision and regulation by the PRC government. The Ministry of Information Industry, pursuant to the authority delegated to it by the PRC's State Council, is responsible for formulating the telecommunications industry policies and regulations, including the regulation and setting of tariff levels for basic telecommunications services, such as local and long distance telephone services, managed data services, leased line and interconnection arrangements.

##### **Organization**

The Company was incorporated in the PRC on September 10, 2002 as part of the reorganization (the Restructuring) of China Telecommunications Corporation (China Telecom) and together with its subsidiaries other than the Company are referred to as China Telecom Group), a state-owned enterprise which is under the supervision and regulation of the Ministry of Information Industry. In November 2001, pursuant to a further industry restructuring plan approved by the State Council, China Telecom's wireline telecommunications networks and related operations in 10 northern provinces, municipalities and autonomous regions of the PRC were transferred to China Netcom Group. China Telecom retained the wireline telecommunications networks and related operations of 21 provinces, municipalities and autonomous regions of the PRC, including those of the Company's subsidiaries. In accordance with this industry restructuring plan, China Telecom and China Netcom Group own 70% and 30%, respectively, of the nationwide inter-provincial optic fibers.

In connection with the Restructuring, China Telecom transferred to the Company the wireline telecommunications business and related operations in Shanghai Municipality, Guangdong Province, Jiangsu Province and Zhejiang Province together with the related assets and liabilities (the Predecessor Operations) in consideration for 68,317 million ordinary domestic shares of the Company. The shares issued to China Telecom have a par value of RMB1.00 each and represented the entire registered and issued share capital of the Company of that date. In connection with the Restructuring, certain assets historically associated with the Predecessor Operations were not transferred to the Company and were retained by China Telecom. These assets, which amounted to RMB11,285 as of December 31, 2001, primarily related to investments in non-telecommunications industries, inter-provincial transmission optic fibres and properties. As a result of the segregation and separate management of these assets by China Telecom beginning December 31, 2001, the assets retained by China Telecom were reflected as a

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distribution to China Telecom in the consolidated statement of shareholders' equity as of December 31, 2001.

Pursuant to the resolution passed by the Company's independent shareholders at an Extraordinary General Meeting held on December 15, 2003, the Company acquired the entire equity interests in Anhui Telecom Company Limited, Fujian Telecom Company Limited, Jiangxi Telecom Company Limited, Guangxi Telecom Company Limited, Chongqing Telecom Company Limited and Sichuan Telecom Company Limited (collectively the First Acquired Group) and certain network management and research and development facilities from China Telecom for a total purchase price of RMB46,000 on December 31, 2003 (hereinafter, referred to as the First Acquisition). The purchase price consisted of a cash payment of RMB11,000 and a long-term payable of RMB35,000 (see Note 12). Prior to the First Acquisition and effective December 31, 2002, China Telecom transferred the wireline telecommunications business and related operations in Anhui Province, Fujian Province, Jiangxi Province, Guangxi

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**CHINA TELECOM CORPORATION LIMITED AND SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

(All amounts in millions, except per share data)

**1. PRINCIPAL ACTIVITIES, ORGANIZATION AND BASIS OF PRESENTATION (continued)**

**Organization (continued)**

Zhuang Autonomous Region, Chongqing Municipality and Sichuan Province together with the related assets and liabilities in consideration for the entire equity interests in each of the entities of the First Acquired Group. Certain assets historically associated with these operations were retained by China Telecom, and as of December 31, 2002, these assets amounted to RMB5,189 and consisted primarily of investments in non-telecommunications industries and properties.

Pursuant to the resolution passed by the Company's independent shareholders at an Extraordinary General Meeting held on June 9, 2004, the Company acquired the entire equity interests in Hubei Telecom Company Limited, Hunan Telecom Company Limited, Hainan Telecom Company Limited, Guizhou Telecom Company Limited, Yunnan Telecom Company Limited, Shaanxi Telecom Company Limited, Gansu Telecom Company Limited, Qinghai Telecom Company Limited, Ningxia Telecom Company Limited and Xinjiang Telecom Company Limited (collectively the Second Acquired Group) from China Telecom for a total purchase price of RMB27,800 on June 30, 2004 (hereinafter, referred to as the Second Acquisition). The purchase price consisted of a cash payment of RMB8,340 and a long-term payable of RMB19,460. On June 30, 2004, the Company repaid RMB4,310 of this payable amount using the net proceeds from issue of new H shares in May 2004 (see Note 12). Prior to the Second Acquisition and effective December 31, 2003, China Telecom transferred the wireline telecommunications business and related operations in Hubei Province, Hunan Province, Hainan Province, Guizhou Province, Yunnan Province, Shaanxi Province, Gansu Province, Qinghai Province, Ningxia Hui Autonomous Region and Xinjiang Uygur Autonomous Region together with the related assets and liabilities in consideration for the entire equity interests in each of the entities of the Second Acquired Group. Certain assets historically associated with these operations were retained by China Telecom, and as of December 31, 2003, these assets amounted to RMB10,762 and consisted primarily of investments in non-telecommunications industries and properties.

**Basis of presentation**

Since China Telecom controlled the Predecessor Operations transferred to the Company and continues to control the Company, the accompanying consolidated financial statements for the periods prior to the legal formation of the Company have been prepared as a reorganization of entities under common control in a manner similar to a pooling-of-interests (as-if-pooling-of-interests accounting). Accordingly, under as-if-pooling-of-interests accounting, the assets and liabilities of the Predecessor Operations transferred to the Company in connection with the Restructuring have been accounted for at historical amounts.

In addition, as the First Acquired Group and the Second Acquired Group (the Acquired Groups) were under the common control of China Telecom, the First Acquisition and the Second Acquisition (the Acquisitions) have been reflected in the accompanying consolidated financial statements as a combination of entities under common control in a manner similar to a pooling-of-interests. Accordingly, the assets and liabilities of the Acquired Groups have been accounted for at historical amounts and the consolidated financial statements of the Company prior to the Acquisitions have been restated to include the results of operations and assets and liabilities of the Acquired Groups on a combined basis.



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The assets retained by China Telecom in respect of the Acquisitions were reflected as distributions to China Telecom in the consolidated statement of shareholders' equity as of December 31, 2002 and December 31, 2003 respectively. The considerations paid by the Company for the acquisition of the Acquired Groups have been accounted for as equity transactions in the consolidated statement of shareholders' equity.

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**Table of Contents****CHINA TELECOM CORPORATION LIMITED AND SUBSIDIARIES****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

(All amounts in millions, except per share data)

**1. PRINCIPAL ACTIVITIES, ORGANIZATION AND BASIS OF PRESENTATION (continued)****Basis of presentation (continued)**

The results of operations for the years ended December 31, 2002 and 2003 and the financial condition and shareholders' equity as of December 31, 2003, January 1, 2003 and January 1, 2002 previously reported by the Group and the Second Acquired Group and the combined amounts presented in the accompanying consolidated financial statements are set out below:

	The Group (as previously reported)	The Second Acquired Group	Combined
	RMB	RMB	RMB
Results of operations:			
2002:			
Operating revenues	109,564	31,342	140,906
Operating income/(loss)	25,997	(889)	25,108
Net income/(loss)	9,773	(1,554)	8,219
Basic earnings/(loss) per share (RMB)	0.14	(0.02)	0.12
2003:			
Operating revenue	118,451	33,102	151,553
Operating income	32,448	404	32,852
Net income/(loss)	24,686	(10,804)	13,882
Basic earnings/(loss) per share (RMB)	0.33	(0.15)	0.18
Financial condition:			
Current assets as of December 31, 2003	25,504	7,589	33,093
Total assets as of December 31, 2003	305,605	98,337	403,942
Current liabilities as of December 31, 2003	96,666	52,469	149,135
Total liabilities as of December 31, 2003	173,064	78,815	251,879
Shareholders' equity as of December 31, 2003	131,272	19,522	150,794
Shareholders' equity as of January 1, 2003	152,848	34,177	187,025
Shareholders' equity as of January 1, 2002	135,156	34,316	169,472

For the periods presented, all significant balances and transactions between the Group and the Acquired Groups prior to the Acquisitions have been eliminated.

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**CHINA TELECOM CORPORATION LIMITED AND SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

(All amounts in millions, except per share data)

**2. SIGNIFICANT ACCOUNTING POLICIES**

**(a) Basis of preparation**

The accompanying consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ( IFRS ) promulgated by the International Accounting Standards Board ( IASB ). IFRS includes International Accounting Standards ( IAS ) and interpretations.

The consolidated financial statements are prepared on the historical cost basis as modified by the revaluation of certain property, plant and equipment (Note 7). Information relating to the nature of significant differences between IFRS and accounting principles generally accepted in the United States of America ( US GAAP ) and their effect on net income for the years ended December 31, 2002, 2003 and 2004 and on shareholders' equity as of December 31, 2003 and 2004 are set forth in Note 33.

The preparation of the consolidated financial statements in accordance with IFRS and US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The accounting policies described below have been consistently applied by the Group.

The IASB has issued a number of new and revised International Financial Reporting Standards and International Accounting Standards (collectively new IFRSs ) which are effective for accounting periods beginning on or after January 1, 2005.

The Group has not early adopted these new IFRSs in the financial statements for the year ended December 31, 2004. The Group has already commenced an assessment of the impact of these new IFRSs but is not yet in a position to state whether these new IFRSs would have significant impact on its results of operations and financial position.

The consolidated financial statements are expressed in Renminbi ( RMB ), the national currency of the PRC. Solely for the convenience of the reader, the December 31, 2004 consolidated financial statements have been translated into United States dollars at the noon buying rate in New York on December 31, 2004 for cable transfers in RMB as certified for customs purposes by the Federal Reserve Bank of New York of US\$1.00 = RMB8.2765. No representation is made that the RMB amounts could have been, or could be, converted into United States dollars at that rate or at any other certain rate on December 31, 2004, or at any other certain date.

**(b) Basis of consolidation**

A subsidiary is an enterprise controlled by the Company. Control exists when the Company has the power, directly or indirectly, to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities.

The financial results of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases, and the share attributable to minority interests is deducted from or added to income before minority interests. All significant intercompany balances and transactions and any unrealized gains/losses arising from intercompany transactions are eliminated on consolidation.

An associate is a company, not being a subsidiary, in which the Group exercises significant influence over its management. Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control over those policies.

The consolidated statement of income includes the Group's share of the results of its associates for the period. In the consolidated balance sheet, interests in associates are stated at the Group's attributable share of net assets.

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**CHINA TELECOM CORPORATION LIMITED AND SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

(All amounts in millions, except per share data)

**2. SIGNIFICANT ACCOUNTING POLICIES (continued)**

**(c) Translation of foreign currencies**

The functional and reporting currency of the Group is RMB. Foreign currency transactions during the year are translated into RMB at the applicable rates of exchange quoted by the People's Bank of China ( PBOC rates ) prevailing on the transaction dates. Foreign currency monetary assets and liabilities are translated into RMB at the applicable PBOC rates at the balance sheet date.

Exchange differences, other than those capitalized as construction in progress, are recognized as income or expense in the consolidated statement of income. For the periods presented, no exchange differences were capitalized.

**(d) Cash and cash equivalents**

Cash and cash equivalents comprise cash at bank and in hand and time deposits with original maturities of three months or less when purchased. Cash equivalents are stated at cost, which approximates fair value. None of the Group's cash and cash equivalents is restricted as to withdrawal.

**(e) Accounts receivable**

Accounts receivable are stated at cost less allowance for doubtful accounts. An allowance for doubtful accounts is provided based upon the evaluation of the recoverability of these accounts at the balance sheet date.

**(f) Inventories**

Inventories consist of materials and supplies used in maintaining the wireline telecommunications network and goods for resale. Materials and supplies are valued at cost less a provision for obsolescence.

Inventories that are held for resale are stated at the lower of cost and net realizable value. Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

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**CHINA TELECOM CORPORATION LIMITED AND SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

(All amounts in millions, except per share data)

**2. SIGNIFICANT ACCOUNTING POLICIES (continued)**

**(g) Property, plant and equipment**

Property, plant and equipment are initially recorded at cost, less subsequent accumulated depreciation and impairment losses (Note 2(k)). The cost of an asset comprises its purchase price, any directly attributable costs of bringing the asset to working condition and location for its intended use and the cost of borrowed funds used during the periods of construction. Expenditure incurred after the asset has been put into operation is capitalized only when it increases the future economic benefits embodied in the item of property, plant and equipment. All other expenditure, including the cost of repairs and maintenance, is expensed as it is incurred.

Subsequent to the revaluations (Note 7) which were based on depreciated replacement costs, property, plant and equipment are carried at revalued amount, being the fair value at the date of the revaluation, less subsequent accumulated depreciation and impairment losses. When an item of property, plant and equipment is revalued, any accumulated depreciation at the date of the revaluation is restated proportionately with the change in the gross carrying amount of the asset so that the carrying amount of the asset after revaluation equals its revalued amount. The separate classes into which the Company groups assets for the revaluation are buildings and improvements; telecommunications network plant and transmission and switching equipment; and furniture, fixture, motor vehicles and other equipment. When an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs is revalued simultaneously. When an asset's carrying amount is increased as a result of a revaluation, the increase is credited directly to shareholders' equity under the component of revaluation reserve. However, a revaluation increase is recognized as income to the extent that it reverses a revaluation decrease of the same asset previously recognized as an expense. When an asset's carrying amount is decreased as a result of a revaluation, the decrease is recognized as an expense in the consolidated statement of income. However, a revaluation decrease is charged directly against any related revaluation surplus to the extent that the decrease does not exceed the amount held in the revaluation reserve in respect of that same asset. Revaluations are performed with sufficient regularity such that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date. Revaluations are performed annually on items which experience significant and volatile movements in fair value while items which experience insignificant movements in fair value are revalued every three years.

Assets acquired under leasing agreements which effectively transfer substantially all the risks and benefits incidental to ownership from the lessor to the lessee are classified as assets under finance leases. Assets under finance leases are initially recorded at amounts equivalent to the present value of the minimum lease payments (computed using the rate of interest implicit in the lease) which approximate the fair value at the inception of the lease. The net present value of the future minimum lease payments is recorded correspondingly as a finance lease obligation. Assets under finance leases are amortized over their estimated useful lives. The carrying amount of the Group's assets under finance leases as of December 31, 2003 and 2004 were RMB239 and RMB314, respectively.

Gains or losses arising from retirement or disposal of property, plant and equipment are determined as the difference between the net disposal proceeds and the carrying amount of the asset and are recognized as income or expense in the consolidated statement of income on the date of disposal. On disposal of a revalued asset, the related revaluation surplus is transferred from the revaluation reserve to retained earnings.

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Depreciation is provided to write off the cost/revalued amount of each asset over its estimated useful life on a straight-line basis, after taking into account its estimated residual value, as follows:

	<b>Depreciable lives</b>
	<b><u>primarily range from</u></b>
Buildings and improvements	8 to 30 years
Telecommunications network plant, transmission and switching equipment	6 to 10 years
Furniture, fixture, motor vehicles and other equipment	4 to 10 years

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**CHINA TELECOM CORPORATION LIMITED AND SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

(All amounts in millions, except per share data)

**2. SIGNIFICANT ACCOUNTING POLICIES (continued)**

**(h) Lease prepayments**

Lease prepayments represent land use rights paid to the PRC's land bureau. Land use rights are carried at cost and are written off on a straight-line basis over the respective periods of the rights which range from 20 years to 70 years.

**(i) Construction in progress**

Construction in progress represents buildings, telecommunications network plant, transmission and switching equipment and other equipment under construction and pending installation, and is stated at cost less impairment losses (Note 2(k)). Cost comprises direct costs of construction as well as interest charges, and foreign exchange differences on related borrowed funds to the extent that they are regarded as an adjustment to interest charges, during the periods of construction. Capitalization of these costs ceases and the construction in progress is transferred to property, plant and equipment when the asset is substantially ready for its intended use.

No depreciation is provided in respect of construction in progress.

**(j) Investments**

Investments in non-marketable equity securities are stated at cost less provision for impairment losses (Note 2(k)). A provision is made where, in the opinion of management, the carrying amount of the investments exceeds its recoverable amount.

**(k) Impairment**

The carrying amounts of the Group's long-lived assets, including property, plant and equipment, are reviewed periodically in order to assess whether the recoverable amounts have declined below the carrying amounts. These assets are tested for impairment whenever events or changes in circumstances indicate that their recorded carrying amounts may not be recoverable. When such a decline has occurred, the carrying amount is reduced to the recoverable amount. The amount of the reduction is recognized as an expense in the consolidated statement of income. The recoverable amount is the greater of the net selling price and the value in use. In determining the value in use, expected future cash flows generated by the assets are discounted to their present value. For the year ended December 31, 2004, a provision for impairment loss of RMB88

was made to fully impair the carrying value of certain equipment for outdated telecommunications services.

**(l) Revenue recognition**

The Group's revenues are principally derived from the provision of local, domestic long distance ( DLD ) and international long distance ( ILD ) telephone services which consist of (i) usage charges for telephone services, which vary depending on the day, the time of day, distance and duration of the telephone call, (ii) a monthly telephone service fee, (iii) service activation and installation fees, and (iv) charges for value-added telecommunications services, such as call waiting, call diverting and caller number display. The Group records wireline service revenues over the periods they are earned as follows:

- (i) Revenues derived from local, DLD and ILD telephone usage are recognized as the services are provided.
- (ii) Upfront fees received for activation of wireline services and wireline installation charges are deferred and recognized over the expected customer relationship period. The related direct incremental customer acquisition costs are deferred to the extent of the upfront fees and are amortized over the same expected customer relationship period.

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**CHINA TELECOM CORPORATION LIMITED AND SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

(All amounts in millions, except per share data)

**2. SIGNIFICANT ACCOUNTING POLICIES (continued)**

**(l) Revenue recognition (continued)**

- (iii) Monthly telephone service fees are recognized in the month during which the telephone services are provided to customers.
- (iv) Revenues from sale of prepaid calling cards are recognized as the cards are used by customers.
- (v) Revenues derived from value-added telecommunications services are recognized when the services are provided to customers.

Other related wireline telecommunications service revenues are recognized as follows:

- (i) Revenues from the provision of Internet and managed data services are recognized when the services are provided to customers.
- (ii) Interconnection fees from domestic and foreign telecommunications operators are recognized when the services are rendered as measured by the minutes of traffic processed.
- (iii) Lease income from operating leases is recognized over the term of the lease.
- (iv) Sale of customer-end equipment is recognized on delivery of the equipment to customers and when the significant risks and rewards of ownership and title have been transferred to the customers.

**(m) Advertising and promotion expense**

The costs for advertising and promoting the Group's wireline telecommunications services are expensed as incurred. Advertising and promotion expense, which is included in selling, general and administrative expenses, were RMB2,505, RMB5,758 and RMB8,701 for the years ended December 31, 2002, 2003, and 2004 respectively.

**(n) Net financing costs**

Net financing costs comprise interest income on bank deposits, interest expense on borrowings, and foreign exchange gains and losses. Interest income from bank deposits is recognized on a time proportion basis that takes into account the effective yield on the asset.

Interest costs incurred in connection with borrowings are expensed as incurred, except to the extent that they are capitalized as being directly attributable to the construction of an asset which necessarily takes a substantial period of time to get ready for its intended use.

**(o) Research and development expense**

Research and development expenditure is expensed as incurred. For the years ended December 31, 2002, 2003 and 2004, research and development expense were RMB237, RMB166 and RMB172 respectively.

**(p) Employee benefits**

The Group's contributions to defined contribution retirement plans administered by the PRC government are recognized as an expense in the consolidated statement of income. Further information is set out in Note 29.

**(q) Provisions**

A provision is recognized in the consolidated balance sheet when the Group has a legal or constructive obligation as a result of a past event, and it is probable that an outflow of economic benefits will be required to settle the obligation.

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**Table of Contents****CHINA TELECOM CORPORATION LIMITED AND SUBSIDIARIES****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

(All amounts in millions, except per share data)

**2. SIGNIFICANT ACCOUNTING POLICIES (continued)****(r) Income tax**

Income tax comprises current and deferred tax. Current tax is calculated on the taxable income for the year by applying the applicable tax rates. Deferred tax is provided using the balance sheet liability method, providing for all temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The amount of deferred tax is calculated on the basis of the enacted tax rates that are expected to apply in the period when the asset is realized or the liability is settled. The effect on deferred tax of any changes in tax rates is charged or credited to the consolidated statement of income, except for the effect of a change in tax rate that results in a change in the carrying amount of deferred tax assets and liabilities is charged or credited directly to shareholders' equity, to the extent that such deferred tax assets and liabilities are previously charged or credited to equity. A deferred tax asset is recognized only to the extent that it is probable that future taxable income will be available against which the asset can be utilized. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

**(s) Dividends**

Dividends are recognized as a liability in the period in which they are declared.

**(t) Segmental reporting**

A business segment is a distinguishable component of the Group that is engaged in providing products or services and is subject to risks and rewards that are different from those of other segments. For the periods presented, the Group has one operating segment which is the provision of wireline telecommunications services. All of the Group's operating activities are carried out in the PRC.

**3. CASH AND CASH EQUIVALENTS**

**December 31,**

<b>2003</b>	<b>2004</b>
-------------	-------------

	RMB	RMB
Cash at bank and in hand	12,451	10,512
Time deposits with maturity within three months	270	2,953
	<u>12,721</u>	<u>13,465</u>

#### 4. ACCOUNTS RECEIVABLE, NET

Accounts receivable, net, are analyzed as follows:

	December 31,	
	2003	2004
	RMB	RMB
Accounts receivable	14,769	15,603
Less: Allowance for doubtful accounts	(1,818)	(1,682)
	<u>12,951</u>	<u>13,921</u>

Amounts due from the provision of wireline telecommunications services to residential and business customers are due within 30 days from the date of billing. Customers who have accounts overdue by more than 90 days will have their services disconnected.

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(All amounts in millions, except per share data)

**4. ACCOUNTS RECEIVABLE, NET (continued)**

The following table summarizes the changes in the allowance for doubtful accounts for each of the years in the three-year period ended December 31, 2004:

	<u>Year ended December 31,</u>		
	<u>2002</u>	<u>2003</u>	<u>2004</u>
	<u>RMB</u>	<u>RMB</u>	<u>RMB</u>
At beginning of year	1,853	1,859	1,818
Provision for doubtful accounts	1,004	1,037	1,121
Accounts receivable written off	(998)	(1,078)	(1,257)
	<u>1,859</u>	<u>1,818</u>	<u>1,682</u>

**5. INVENTORIES**

Inventories represent:

	<u>December 31,</u>	
	<u>2003</u>	<u>2004</u>
	<u>RMB</u>	<u>RMB</u>
Materials and supplies	2,104	1,907
Goods for resale	1,149	860
	<u>3,253</u>	<u>2,767</u>

**6. PREPAYMENTS AND OTHER CURRENT ASSETS**

Prepayments and other current assets represent:

	<b>December 31,</b>	
	<b>2003</b>	<b>2004</b>
	<b>RMB</b>	<b>RMB</b>
Amounts due from China Telecom Group	844	640
Prepayments in connection with construction work and equipment purchases	609	854
Prepaid expenses and deposits	609	607
Other receivables	1,633	963
	<u>3,695</u>	<u>3,064</u>



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(All amounts in millions, except per share data)

**7. PROPERTY, PLANT AND EQUIPMENT, NET**

	Buildings and improvements	Telecommunications network plant and equipment	Furniture, fixture, motor vehicles and other equipment	Total
	RMB	RMB	RMB	RMB
<b>Cost/valuation:</b>				
Balance as of January 1, 2004	60,939	421,014	19,264	501,217
Additions	178	1,469	696	2,343
Transferred from construction in progress	4,380	49,775	1,976	56,131
Disposals	(119)	(14,195)	(1,259)	(15,573)
Reclassification	22	17	(39)	
Revaluations	944	(8,776)		(7,832)
<b>Balance as of December 31, 2004</b>	<b>66,344</b>	<b>449,304</b>	<b>20,638</b>	<b>536,286</b>
<b>Accumulated depreciation:</b>				
Balance as of January 1, 2004	(8,331)	(174,961)	(8,029)	(191,321)
Depreciation charge for the year	(2,646)	(41,246)	(2,930)	(46,822)
Provision for impairment		(88)		(88)
Written back on disposals	37	13,214	1,070	14,321
Reclassification	(11)	(5)	16	
Revaluations	(67)	7,870		7,803
<b>Balance as of December 31, 2004</b>	<b>(11,018)</b>	<b>(195,216)</b>	<b>(9,873)</b>	<b>(216,107)</b>
<b>Net book value as of December 31, 2004</b>	<b>55,326</b>	<b>254,088</b>	<b>10,765</b>	<b>320,179</b>
<b>Net book value as of December 31, 2003</b>	<b>52,608</b>	<b>246,053</b>	<b>11,235</b>	<b>309,896</b>

In connection with the Restructuring, the property, plant and equipment of the Predecessor Operations as of December 31, 2001 were revalued as required by the relevant PRC rules and regulations for each asset class by Beijing China Enterprise Appraisal Co., Ltd. (the PRC valuers), independent valuers registered in the PRC, on a depreciated replacement cost basis. The value of the property, plant and equipment was determined at RMB138,623. The surplus on revaluation of certain property, plant and equipment totaling RMB4,154 was credited to the revaluation reserve while the deficit arising from the revaluation of certain property, plant and equipment totaling RMB11,930 was recognized as an expense for the year ended December 31, 2001.

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In connection with the First Acquisition, the property, plant and equipment of the First Acquired Group as of December 31, 2002 were revalued as required by the relevant PRC rules and regulations for each asset class by the PRC valuers on a depreciated replacement cost basis. The value of the property, plant and equipment was determined at RMB71,596. The surplus on revaluation of certain property, plant and equipment totaling RMB760 was credited to the revaluation reserve while the deficit arising from the revaluation of certain property, plant and equipment totaling RMB14,690 was recognized as an expense for the year ended December 31, 2002.

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(All amounts in millions, except per share data)

**7. PROPERTY, PLANT AND EQUIPMENT, NET (continued)**

In connection with the Second Acquisition, the property, plant and equipment of the Second Acquired Group as of December 31, 2003 were revalued as required by the relevant PRC rules and regulations for each asset class by the PRC valuers on a depreciated replacement cost basis. The value of the property, plant and equipment was determined at RMB74,685. The surplus on revaluation of certain property, plant and equipment totaling RMB1,537 was credited to the revaluation reserve while the deficit arising from the revaluation of certain property, plant and equipment totaling RMB14,832 was recognized as an expense for the year ended December 31, 2003.

In accordance with the Group's accounting policy (Note 2(g)), the property, plant and equipment of the Group as of December 31, 2004 were revalued for each asset class by the directors of the Company on a depreciated replacement cost basis. The value of the property, plant and equipment was determined at RMB320,179. The surplus on revaluation of certain property, plant and equipment totaling RMB1,233 was credited to the revaluation reserve while the deficit arising from the revaluation of certain property, plant and equipment totaling RMB1,262 was recognized as an expense for the year ended December 31, 2004.

The following is a summary of the carrying value of the Group's property, plant and equipment prior to the revaluation and the revalued amounts of these assets as of December 31, 2004:

	Carrying value prior to revaluation	Revaluation surplus	Revaluation deficit	Revalued amounts
	RMB	RMB	RMB	RMB
Building and improvements	54,449	877		55,326
Telecommunications network plant and equipment	254,994	356	(1,262)	254,088
Furniture, fixture, motor vehicles and other equipment	10,765			10,765
	<u>320,208</u>	<u>1,233</u>	<u>(1,262)</u>	<u>320,179</u>

**8. CONSTRUCTION IN PROGRESS**

RMB

Balance as of January 1, 2004	31,617
Additions	53,964
Transferred to property, plant and equipment	(56,131)
Balance as of December 31, 2004	29,450

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**9. INTERESTS IN ASSOCIATES**

	<b>December 31,</b>	
	<b>2003</b>	<b>2004</b>
	<b>RMB</b>	<b>RMB</b>
Share of net assets	513	511

The Group's interests in associates are accounted for under the equity method and are individually and in aggregate not material to the Group's financial conditions or results of operations for all periods presented. Details of the Group's principal associates are as follows:

<b><u>Name of company</u></b>	<b><u>Attributable equity interest</u></b>	<b><u>Principal activities</u></b>
Shenzhen Shekou Telecommunications Company Limited	50%	Provision of telecommunications services
Shanghai Information Investment Incorporation	24%	Provision of information technology consultancy services

The above associates are established in the PRC and are not traded on any stock exchange.

**10. INVESTMENTS**

	<b>December 31,</b>	
	<b>2003</b>	<b>2004</b>
	<b>RMB</b>	<b>RMB</b>
Unlisted equity investments	206	200

Unlisted equity investments mainly represent the Group's various interests in PRC private enterprises which are mainly engaged in the provision of information technology services and Internet contents. These investments are accounted for at cost, less provision for any impairment. The Group has no investments in marketable securities.

## 11. DEFERRED TAX ASSETS AND LIABILITIES

Deferred tax assets and deferred tax liabilities are attributable to the items set out below:

	Assets		Liabilities		Net balance	
	2003	2004	2003	2004	2003	2004
	RMB	RMB	RMB	RMB	RMB	RMB
<i>Current</i>						
Provisions, primarily for receivables	198	286			198	286
<i>Non-Current</i>						
Property, plant and equipment	67	516	(579)	(1,295)	(512)	(779)
Deferred revenues and installation costs	1,788	1,942	(746)	(1,007)	1,042	935
Land use rights	8,470	8,061			8,470	8,061
<b>Deferred tax assets/(liabilities)</b>	<b>10,523</b>	<b>10,805</b>	<b>(1,325)</b>	<b>(2,302)</b>	<b>9,198</b>	<b>8,503</b>

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**11. DEFERRED TAX ASSETS AND LIABILITIES (continued)**

A valuation allowance on deferred tax assets is recorded if it is more likely than not that some portion or all of the deferred tax assets will not be realized through recovery of taxes previously paid and/or future taxable income. The allowance is subject to ongoing adjustments based on changes in circumstances that affect the Group's assessment of the realizability of the deferred tax assets. The Group has reviewed its deferred tax assets as of December 31, 2002, 2003 and 2004. Based on the level of historical taxable income and projections for future taxable income over the periods which the deferred tax assets are deductible, management believes that it is more likely than not the Group will realize the benefits of these temporary differences. Therefore, no valuation allowances were provided for the years ended December 31, 2002, 2003 and 2004 in respect of deferred tax assets arising from temporary differences.

Movements in temporary differences for the three-year period ended December 31, 2004 are as follows:

	Note	Balance as of January 1, 2002	Recognized in statement of income	Recognized in shareholders equity	Balance as of December 31, 2002
		RMB	RMB	RMB	RMB
<i>Current</i>					
Provisions, primarily for receivables	(ii)	764	160	(369)	555
<i>Non-current</i>					
Property, plant and equipment	(ii)	(10,294)	3,627	987	(5,680)
Deferred revenues and installation costs	(ii)	1,123	736	(598)	1,261
Tax loss	(i)		1,704	(1,704)	
Land use rights	(iii)	4,059	(75)	2,408	6,392
Net deferred tax (liabilities)/assets		(4,348)	6,152	724	2,528
			(Note 23)		
	Note	Balance as of January 1, 2003	Recognized in statement of income	Recognized in shareholders equity	Balance as of December 31, 2003
		RMB	RMB	RMB	RMB
<i>Current</i>					
Provisions, primarily for receivables	(ii)	555	17	(374)	198
<i>Non-current</i>					

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Property, plant and equipment	(ii)	(5,680)	4,042	1,126	(512)
Deferred revenues and installation costs	(ii)	1,261	383	(602)	1,042
Tax loss	(i)		1,234	(1,234)	
Land use rights	(iii)	6,392	(131)	2,209	8,470
		<u>2,528</u>	<u>5,545</u>	<u>1,125</u>	<u>9,198</u>
Net deferred tax assets					
			(Note 23)		
			<b>Recognized</b>		
		<b>Balance as</b>	<b>in statement</b>	<b>Recognized in</b>	<b>Balance as of</b>
		<b>of January 1,</b>	<b>of income</b>	<b>shareholders</b>	<b>December 31,</b>
	<b>Note</b>	<b>2004</b>		<b>equity</b>	<b>2004</b>
	<u>      </u>	<u>      </u>	<u>      </u>	<u>      </u>	<u>      </u>
		<b>RMB</b>	<b>RMB</b>	<b>RMB</b>	<b>RMB</b>
<i>Current</i>					
Provisions, primarily for receivables		198	88		286
<i>Non-current</i>					
Property, plant and equipment	(iv)	(512)	111	(378)	(779)
Deferred revenues and installation costs		1,042	(107)		935
Land use rights	(iii)	8,470	(165)	(244)	8,061
		<u>9,198</u>	<u>(73)</u>	<u>(622)</u>	<u>8,503</u>
Net deferred tax assets					
			(Note 23)		



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**CHINA TELECOM CORPORATION LIMITED AND SUBSIDIARIES**

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**11. DEFERRED TAX ASSETS AND LIABILITIES (continued)**

Note:

- (i) Represents net tax loss carry forward of the Acquired Groups for the years ended December 31, 2002 and 2003. As the tax loss was utilized by China Telecom in the same tax year, the utilization of the deferred tax asset was reflected as a distribution to China Telecom in the statement of shareholders' equity.
  - (ii) As described in Note 7, in connection with the Restructuring and the Acquisitions, the property, plant and equipment of the Predecessor Operations, the First Acquired Group and the Second Acquired Group were revalued as of December 31, 2001, 2002 and 2003, respectively. The tax bases of these assets were adjusted to conform to the respective revalued amounts. In addition, in connection with the Restructuring and the Acquisitions, the tax bases of the assets and liabilities of the Predecessor Operations and the Acquired Groups that gave rise to the temporary differences were adjusted to conform to the related financial carrying amounts. As a result, the timing differences that gave rise to the net deferred tax liabilities relating to these items were eliminated. The reductions in net deferred tax liabilities of RMB4,887 as of December 31, 2001, RMB20 as of December 31, 2002 and RMB150 as of December 31, 2003 were credited to shareholders' equity.
  - (iii) In connection with the Restructuring and the Acquisitions, the land use rights of the Predecessor Operations, the First Acquired Group and the Second Acquired Group, which as of December 31, 2001, 2002 and 2003 had a total carrying amount of RMB2,638, RMB617 and RMB1,251, respectively, were revalued as required by the relevant PRC rules and regulations. The revalued amounts of the Predecessor Operations and the Acquired Groups' land use rights as of December 31, 2001, 2002 and 2003 were determined at RMB14,939, RMB7,913 and RMB8,464, respectively. The tax bases of the land use rights were adjusted to conform to such revalued amounts. The land use rights were not revalued for financial reporting purposes and accordingly, deferred tax assets were created with carrying amounts of RMB4,059, RMB2,408 and RMB2,209 as of December 31, 2001, 2002 and 2003, respectively, with corresponding increases in shareholders' equity. Based upon the level of historical taxable income and projections of future taxable income, management believes that it is more likely than not the Group will realize the benefits of the deferred tax assets.
- In 2004, certain subsidiaries of the Group with operations in the western region of the PRC obtained approval from tax authority to reduce the income tax rate from 33% to 15% for the period from January 1, 2004 to December 31, 2010. In addition, certain subsidiaries of the Group obtained approval from tax authority to reduce income tax rate from 33% to 15% with effect from January 1, 2004. Accordingly, the effect of the change in tax rate on the amount of the deferred tax asset expected to be realized during the relevant periods amounting to RMB244 was charged to shareholders' equity.
- (iv) As described in Note 7, in accordance with the Group's accounting policy, the property, plant and equipment of the Group were revalued as of December 31, 2004. The tax bases of these assets were not adjusted to conform to such revalued amounts and accordingly, a deferred tax asset and a deferred tax liability in the respective amount of RMB356 and RMB378 in respect of the revaluation deficit and surplus were recognized. The deferred tax asset was credited to the income statement while the deferred tax liability was charged to shareholders' equity.



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**12. SHORT-TERM AND LONG-TERM DEBT**

The Group's short-term debt comprises:

	<b>December 31,</b>	
	<b>2003</b>	<b>2004</b>
	<b>RMB</b>	<b>RMB</b>
Bank loans	56,243	55,887
Loans from China Telecom Group		10,089
<b>Total short-term debt</b>	<b>56,243</b>	<b>65,976</b>

Weighted average interest rate of the Group's short-term debt as of December 31, 2003 and 2004 was 4.6% and 4.4%, respectively. The loans from China Telecom Group bear interest at fixed rates ranging from 2.0% to 5.0% per annum, are unsecured and are repayable within one year.

The Group's long-term debt comprises:

	<b>Interest rates and final maturity</b>	<b>December 31,</b>	
		<b>2003</b>	<b>2004</b>
		<b>RMB</b>	<b>RMB</b>
<b>Bank loans</b>			
Renminbi denominated	Interest rates ranging from 2.9% to 6.6% per annum with maturities through 2015	38,339	26,859
US Dollars denominated	Interest rates ranging from 0.5% to 9.2% per annum with maturities through 2038	3,922	2,883
Japanese Yen denominated	Interest rates ranging from 0.6% to 3.5% per annum with maturities through 2040	4,180	3,182
Euro denominated	Interest rates ranging from 0.5% to 9.2% per annum with maturities through 2032	1,039	1,053

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Other currencies	73	70
	<u>47,553</u>	<u>34,047</u>
<b>Other loans</b>		
Renminbi denominated	13	11
US Dollars denominated	23	
<b>Amount due to China Telecom</b>		
In connection with the First Acquisition Renminbi denominated (Note(i))	35,000	35,000
In connection with the Second Acquisition Renminbi denominated (Note (ii))		15,150
	<u>82,589</u>	<u>84,208</u>
Total long-term debt	(13,957)	(11,842)
Less: current portion		
Non-current portion	<u>68,632</u>	<u>72,366</u>

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**12. SHORT-TERM AND LONG-TERM DEBT (continued)**

- Note (i) This represents the deferred consideration payable to China Telecom in respect of the First Acquisition (Note 1). The amount is unsecured, and for the first five years after the date of the First Acquisition, the Company pays interest on the outstanding balance at the rate of 5.184% per annum. Thereafter the interest rate is adjusted based on the prevailing market interest rate. This amount is repayable on December 31, 2013 and the Company may, from time to time, repay all or part of the amount at any time until December 31, 2013 without penalty.
- (ii) This represents the remaining balance of the deferred consideration payable to China Telecom in respect of the Second Acquisition (Note 1). The amount is unsecured, and for the first five years after the date of the Second Acquisition, the Company pays interest on the outstanding balance at the rate of 5.184% per annum. Thereafter the interest rate is adjusted based on the prevailing market interest rate. This amount is repayable on June 30, 2014 and the Company may, from time to time, repay all or part of the amount at any time until June 30, 2014 without penalty.

As of December 31, 2004, no bank loans were secured. As of December 31, 2003, bank loans of RMB22 were secured by certain of the Group's property, plant and equipment. The net book value of the property, plant and equipment pledged as security amounted to RMB27 as of December 31, 2003.

The aggregate maturities of the Group's long-term debt subsequent to December 31, 2004 are as follows:

	<b>RMB</b>
2004	11,842
2005	10,022
2006	8,343
2007	552
2008	268
Thereafter	53,181
	<b>84,208</b>

The Group's short-term and long-term debts do not contain any financial covenants. As of December 31, 2003 and 2004, the Group had available credit facilities of RMB30,965 and RMB27,855, respectively which it can draw upon.

**13. ACCOUNTS PAYABLE**

Accounts payable are analyzed as follows:

	<u>December 31,</u>	
	<u>2003</u>	<u>2004</u>
	<u>RMB</u>	<u>RMB</u>
Third parties	28,367	26,591
China Telecom Group	7,262	7,067
	<u>35,629</u>	<u>33,658</u>

Amounts due to China Telecom Group are repayable in accordance with normal commercial terms.

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**14. ACCRUED EXPENSES AND OTHER PAYABLES**

Accrued expenses and other payables represent:

	<b>December 31,</b>	
	<b>2003</b>	<b>2004</b>
	<b>RMB</b>	<b>RMB</b>
Amounts due to China Telecom Group	5,165	4,889
Accrued expenses	17,150	15,923
Customer deposits and receipts in advance	3,689	6,719
	<b>26,004</b>	<b>27,531</b>

**15. FINANCE LEASE OBLIGATIONS**

Obligations under finance leases are analyzed as follows:

	<b>December 31,</b>	
	<b>2003</b>	<b>2004</b>
	<b>RMB</b>	<b>RMB</b>
Within 1 year	52	163
Between 1 to 2 years	46	110
Between 2 to 3 years		51
Total minimum lease payments	98	324
Less: finance charges related to future periods	(5)	(11)
Present value of minimum lease payments	93	313
Less: current portion	(50)	(156)
Non-current portion	43	157





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**16. DEFERRED REVENUES**

Deferred revenues represent the unearned portion of upfront connection fees and installation fees received from customers and the unused portion of calling cards. Connection fees and installation fees are amortized over the expected customer relationship period of 10 years. Beginning July 1, 2001, connection fees were no longer collected from new customers.

	<b>December 31,</b>	
	<b>2003</b>	<b>2004</b>
	<b>RMB</b>	<b>RMB</b>
Balance at beginning of year	55,921	46,601
Additions for the year		
- installation fees	3,309	2,135
- calling cards	5,451	4,392
	<u>8,760</u>	<u>6,527</u>
Reduction for the year		
- amortization of connection fees	(9,771)	(8,458)
- amortization of installation fees	(2,643)	(2,865)
- usage of calling cards	(5,666)	(5,034)
Balance at end of year	<u>46,601</u>	<u>36,771</u>
Representing:		
- Current portion	13,857	11,589
- Non-current portion	<u>32,744</u>	<u>25,182</u>
	<u>46,601</u>	<u>36,771</u>

Included in other non-current assets are capitalized direct incremental costs associated with the installation of wireline services. As of December 31, 2003 and 2004, the unamortized portion of these costs was RMB12,366 and RMB11,428, respectively.

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**17. SHARE CAPITAL**

	<b>December 31,</b>	
	<b>2003</b>	<b>2004</b>
	<b>RMB</b>	<b>RMB</b>
<b>Registered, issued and fully paid</b>		
67,054,958,321 ordinary domestic shares of RMB 1.00 each	67,587	67,055
13,877,410,000 overseas listed H shares of RMB 1.00 each	8,027	13,877
	<b>75,614</b>	<b>80,932</b>

In May 2004, the Company issued and allotted 5,318,181,818 new H shares with a par value of RMB1.00 each, representing 4,466,693,018 H shares and 8,514,888 American Depositary Shares ( ADS , each representing 100 H shares), at prices of HK\$2.30 per H share and US\$29.49 per ADS, respectively, by way of a global offering to Hong Kong and overseas investors. As part of the global offering, 531,818,182 existing domestic shares of RMB1.00 each owned by China Telecom and the Other Domestic Shareholders were converted into H shares and sold to Hong Kong and overseas investors. The Company raised net proceeds of RMB12,702 from issue of new H shares.

All ordinary domestic shares and H shares rank pari passu in all material respects.

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**18. RESERVES**

	Capital reserve	Share premium	Revaluation reserve	Surplus reserves	Statutory common welfare fund	Other reserves	Retained earnings	Total shareholders equity
	RMB	RMB	RMB	RMB	RMB	RMB	RMB	RMB
Balance as of January 1, 2003, as adjusted (Note 1)	20,955	3,362	4,904	8,121	1,624	65,241	7,204	111,411
Net income							13,882	13,882
Contributions from China Telecom							4,309	4,309
Distributions to China Telecom							(1,234)	(1,234)
Assets distributed to China Telecom in connection with the Second Acquisition							(10,762)	(10,762)
Revaluation surplus			1,537					1,537
Recognition of deferred tax assets						2,209		2,209
Elimination of deferred tax liabilities							150	150
Transfer from retained earnings to other reserves						(11,812)	11,812	
Consideration for the acquisition of the First Acquired Group						(45,649)		(45,649)
Transfer from other reserves to capital reserve	(14,388)					14,388		
Appropriations (Note (i) and (ii))				7,340	1,748		(9,088)	
Dividends							(673)	(673)
Revaluation surplus realized			(17)				17	
Deferred tax on land use rights realized						(131)	131	
Balance as of December 31, 2003	6,567	3,362	6,424	15,461	3,372	24,246	15,748	75,180
Issue of shares, net of issuing expenses of RMB294		7,384						7,384
Net income							28,023	28,023
Contributions from China Telecom							100	100
Transfer from retained earnings to other reserves						2,653	(2,653)	
Consideration for the acquisition of the Second Acquired Group						(27,800)		(27,800)
Transfer from other reserves to capital reserve	(9,371)					9,371		
Revaluation surplus			1,233					1,233
Deferred tax on revaluation surplus of property, plant and equipment						(378)		(378)
Appropriations (Note (i) and (ii))				10,168	2,421		(12,589)	
Dividends (Note 24)							(5,224)	(5,224)
Effect of change in tax rate						(244)		(244)
Revaluation surplus realized			(72)				72	

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Deferred tax on land use rights realized						(165)	165	
Balance as of December 31, 2004	(2,804)	10,746	7,585	25,629	5,793	7,683	23,642	78,274

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**CHINA TELECOM CORPORATION LIMITED AND SUBSIDIARIES**

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**18. RESERVES (continued)**

Note:

- (i) According to the Company's Articles of Association, the Company is required to transfer 10% of its net income, as determined in accordance with the PRC accounting rules and regulations, to a statutory surplus reserve until such reserve balance reaches 50% of the registered capital. The transfer to this reserve must be made before distribution of any dividend to shareholders. For the years ended December 31, 2003 and 2004, the Company transferred RMB1,748 and RMB2,421, respectively, being 10% of the respective year's net income determined in accordance with PRC accounting rules and regulations, to this reserve.

According to the Company's Articles of Association, the Directors authorized, subject to shareholders' approval, for the years ended December 31, 2003 and 2004 the transfer of RMB5,592 and RMB7,747, being 32% of the respective year's net income determined in accordance with PRC accounting rules and regulations, to a discretionary surplus reserve.

The surplus reserves are non-distributable other than liquidation and can be used to make good of previous years' losses, if any, and may be utilized for business expansion or converted into share capital by issuing new shares to existing shareholders in proportion to their shareholdings or by increasing the par value of the shares currently held by them, provided that the remaining reserve balance after such issue is not less than 25% of the registered capital.

- (ii) According to the Company's Articles of Association, the Company is required to transfer 5% to 10% of its net income, as determined in accordance with the PRC accounting rules and regulations, to a statutory common welfare fund. This fund can only be utilized on capital items for the collective benefits of the Company's employees such as construction of dormitories, canteen and other staff welfare facilities. This fund is non-distributable other than on liquidation. The transfer to this fund must be made before distribution of any dividend to shareholders. For the years ended December 31, 2003 and 2004, the Directors authorized, subject to shareholders' approval, the transfer of RMB1,748 and RMB2,421, respectively, being 10% of the respective year's net income determined in accordance with the PRC accounting rules and regulations, to this fund.
- (iii) According to the Company's Articles of Association, the amount of retained earnings available for distribution to shareholders of the Company is the lower of the amount determined in accordance with the PRC accounting rules and regulations and the amount determined in accordance with IFRS. As of December 31, 2003 and 2004, the amount of retained earnings available for distribution was RMB14,212 and RMB20,609, respectively, being the amount determined in accordance with the PRC accounting rules and regulations. Final dividend of approximately RMB5,576 in respect of the financial year 2004 proposed after the balance sheet date has not been recognized as a liability at the balance sheet date (Note 24).

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**19. OPERATING REVENUES**

Operating revenues represent revenues from the provision of wireline telecommunications services. The components of the Group's operating revenues are as follows:

	Note	Year ended December 31,		
		2002	2003	2004
		RMB	RMB	RMB
Upfront connection fees	(i)	10,564	9,771	8,458
Upfront installation fees	(ii)	2,305	2,643	2,865
Monthly fees	(iii)	25,338	27,499	29,827
Local usage fees	(iv)	44,440	45,815	47,646
DLD	(iv)	25,726	25,460	26,231
ILD	(iv)	3,878	3,943	3,788
Internet	(v)	5,998	10,007	14,109
Managed data	(vi)	3,147	3,210	3,015
Interconnections	(vii)	7,524	8,365	10,719
Leased line	(viii)	5,520	5,103	4,154
Others	(ix)	6,466	9,737	10,400
		<b>140,906</b>	<b>151,553</b>	<b>161,212</b>

Note:

- (i) Represent the amortized amount of the upfront fees received for initial activation of wireline services.
- (ii) Represent the amortized amount of the upfront fees received for installation of wireline services.
- (iii) Represent amounts charged to customers each month for their use of the Group's telephone services.
- (iv) Represent usage fees charged to customers for the provision of telephone services.
- (v) Represent amounts charged to customers for the provision of Internet access services.

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- (vi) Represent amounts charged to customers for the provision of managed data transmission services.
- (vii) Represent amounts charged to domestic and foreign telecommunications operators for delivery of calls connecting to the Group's wireline telecommunications networks.
- (viii) Represent lease income from other domestic telecommunications operators and business customers for the usage of the Group's wireline telecommunications networks and is measured by the number of lines leased and the agreed upon rate per line leased. The lease arrangements are primarily on a year to year basis.
- (ix) Represent primarily revenues from provision of value-added telecommunications services to customers, sale and repairs and maintenance of customer-end equipment, and lease of telecommunications network facilities.

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**20. OTHER OPERATING EXPENSES**

Other operating expenses consist of:

	Note	Year ended December 31,		
		2002	2003	2004
		RMB	RMB	RMB
Interconnection charges	(i)	3,115	3,104	4,095
Donations		36	41	17
Others		37	31	27
		<u>3,188</u>	<u>3,176</u>	<u>4,139</u>

Note:

- (i) Interconnection charges represent amounts incurred for the use of other domestic and foreign telecommunications operators' networks for facilitating the completion of calls that originate from the Group's wireline telecommunications networks.

**21. TOTAL OPERATING EXPENSES**

Total operating expenses for the years ended December 31, 2002, 2003 and 2004 include personnel expenses of RMB18,894, RMB20,812 and RMB23,233, respectively.

**22. NET FINANCE COSTS**

Net finance costs comprise:



	Year ended December 31,		
	2002	2003	2004
	RMB	RMB	RMB
Interest expense incurred	5,494	4,948	6,834
Less: Interest expense capitalized*	(1,668)	(1,608)	(1,467)
Net interest expense	3,826	3,340	5,367
Interest income	(248)	(331)	(231)
Foreign exchange losses	520	647	207
Foreign exchange gains	(27)	(50)	(3)
	4,071	3,606	5,340
*Interest expense was capitalized in construction in progress at the following rates per annum	4.4% to 5.8%	4.3% to 5.5%	4.1% to 5.2%

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**23. INCOME TAX**

Income tax in the consolidated statement of income comprises:

	<u>Year ended December 31,</u>		
	<u>2002</u>	<u>2003</u>	<u>2004</u>
	<u>RMB</u>	<u>RMB</u>	<u>RMB</u>
Provision for PRC income tax	4,296	6,014	5,114
Deferred taxation (Note 11)	(6,152)	(5,545)	73
	<u>(1,856)</u>	<u>469</u>	<u>5,187</u>

A reconciliation of the expected tax with the actual tax (benefit) / expense is as follows:

	<u>Note</u>	<u>Year ended December 31,</u>		
		<u>2002</u>	<u>2003</u>	<u>2004</u>
		<u>RMB</u>	<u>RMB</u>	<u>RMB</u>
Income before income tax and minority interests		6,435	14,407	33,263
Expected PRC income tax expense at statutory tax rate of 33%	(i)	2,124	4,754	10,977
Differential tax rate on subsidiaries' income	(i)	(624)	(314)	(1,608)
Non-deductible expenses	(ii)	1,106	515	294
Non-taxable income	(iii)	(4,139)	(3,659)	(3,266)
Tax credit for domestic equipment purchases		(323)	(827)	(1,210)
Income tax		<u>(1,856)</u>	<u>469</u>	<u>5,187</u>

Note:

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- (i) The provision for PRC current income tax is based on a statutory rate of 33% of the assessable income of the Group as determined in accordance with the relevant income tax rules and regulations of the PRC, except for certain subsidiaries of the Company which are taxed at a preferential rate of 15%.
- (ii) Amounts represent personnel and other miscellaneous expenses in excess of statutory deductible limits for tax purpose.
- (iii) Amounts primarily represent connection fees received from customers which are not subject to income tax.

### **24. DIVIDENDS**

Pursuant to a resolution passed at the Directors' meeting on March 31, 2005, a final dividend of equivalent to HK\$0.065 per share totaling approximately RMB5,576 for the year ended December 31, 2004 was proposed for shareholders' approval at the Annual General Meeting. The dividend has not been provided for in the consolidated financial statements for the year ended December 31, 2004.

Pursuant to the shareholders' approval at the Annual General Meeting held on May 3, 2004, a final dividend of RMB0.069083 equivalent to HK\$0.065 per share totaling RMB5,224 in respect of the year ended December 31, 2003 was declared and was paid on May 20, 2004.

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**25. BASIC EARNINGS PER SHARE**

The calculation of basic earnings per share for the years ended December 31, 2002, 2003 and 2004 is based on the net income of RMB8,219, RMB13,882 and RMB28,023 respectively, and the weighted average number of shares in issue during the year of 69,241,674,942, 75,614,186,503 and 78,839,968,917 shares, respectively. The weighted average number of shares for the year ended December 31, 2004 reflects the issuance of 5,318,181,818 new H shares in May 2004 (Note 17). For the year ended December 31, 2002, the weighted average number of shares reflects as if the 68,317,270,803 shares issued and outstanding upon the legal formation of the Company on September 10, 2002 had been outstanding for all periods presented. The weighted average number of shares for the year ended December 31, 2002 also reflects the issuance of 7,296,915,700 shares in 2002 in connection with the Company's global initial public offering.

The amount of diluted earnings per share is not presented as there were no dilutive potential ordinary shares in existence for all periods presented.

**26. COMMITMENTS AND CONTINGENCIES***Operating lease commitments*

The Group leases business premises through non-cancelable operating leases. These operating leases do not contain provisions for contingent lease rentals. None of the rental agreements contain escalation provisions that may require higher future rental payments nor impose restrictions on dividends, additional debt and/or further leasing.

As of December 31, 2004, future minimum lease payments under non-cancelable operating leases having initial or remaining lease terms of more than one year were as follows:

	<b>RMB</b>
2005	369
2006	187
2007	137
2008	124
2009	127
Thereafter	341

Total minimum lease payments	1,285
------------------------------	-------

Total rental expense in respect of operating leases charged to the consolidated statements of income for the years ended December 31, 2002, 2003 and 2004 were RMB1,136, RMB1,262 and RMB1,271, respectively.

*Capital commitments*

As of December 31, 2004, the Group had capital commitments as follows:

	<b>RMB</b>
Authorized and contracted for	
Properties	918
Telecommunications network plant and equipment	3,947
	<u>4,865</u>
Authorized but not contracted for	
Properties	1,699
Telecommunications network plant and equipment	9,168
	<u>10,867</u>

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**26. COMMITMENTS AND CONTINGENCIES (continued)**

*Contingent liabilities*

(a) The Company and the Group have been advised by their PRC lawyers that, except for liabilities arising out of or relating to the businesses of the Predecessor Operations and the Acquired Groups transferred to the Company in connection with the Restructuring and the Acquisitions, no other liabilities were assumed by the Company or the Group, and the Company or the Group are not jointly and severally liable for other debts and obligations incurred by China Telecom Group prior to the Restructuring and the Acquisitions.

(b) As of December 31, 2004, the Group had no contingent liabilities in respect of guarantees.

The Group monitors the conditions that are subject to the guarantees to identify whether it is probable that a loss has occurred, and recognizes any such losses under guarantees when those losses can be estimated. As of December 31, 2003 and 2004, it was not probable that the Group would be required to make payments under these guarantees. Thus no liability was accrued for losses related to the Group's obligations under these guarantee arrangements.

*Legal contingencies*

The Group is a defendant in certain lawsuits as well as the named party in other proceedings arising in the ordinary course of business. While the outcomes of such contingencies, lawsuits or other proceedings cannot be determined at present, management believes that any resulting liabilities will not have a material adverse effect on the financial position or operating results of the Group.

**27. CONCENTRATION OF RISKS**

*Credit and concentration risks*

The carrying amounts of cash and cash equivalents, time deposits, accounts receivable and other receivables represent the Group's maximum exposure to credit risk in relation to financial assets. The majority of the Group's accounts receivable relate to provision of telecommunications services to residential and corporate customers operating in various industries. The Group performs ongoing credit evaluations of its customers

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financial condition and generally does not require collateral on accounts receivable. The Group maintains an allowance for doubtful accounts and actual losses have been within management's expectations.

The Group has a diversified base of customers. No single customer contributed more than 10% of revenues for the periods presented.

The Group does not have concentrations of available sources of labor, services, franchises, licenses or other rights that could, if suddenly eliminated, severely impact its operations. The Group invests its cash with several large state-owned financial institutions in the PRC.

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**27. CONCENTRATION OF RISKS (continued)**

*Business and economic risks*

The Group conducts its principal operations in the PRC and accordingly is subject to special considerations and significant risks not typically associated with investments in equity securities of United States and Western European companies. These include risks associated with, among others, the political, economic, legal environment and social uncertainties in the PRC, influence of the Ministry of Information Industry over certain aspects of the Group's operations and competition in the telecommunications industry. In addition, the ability to negotiate and implement specific business development projects in a timely and favorable manner may be impacted by political considerations unrelated to or beyond the control of the Group. Although the PRC government has been pursuing economic reform policies for the past two decades, no assurance can be given that the PRC government will continue to pursue such policies or that such policies may not be significantly altered. There is also no guarantee that the PRC government's pursuit of economic reforms will be consistent or effective and as a result, changes in the rate or method of taxation, reduction in tariff protection and other import restrictions, and changes in State policies and regulations affecting the telecommunications industry may have a negative impact on the Group's operating results and financial condition.

*Currency risk*

Substantially all of the revenue-generating operations of the Group are transacted in RMB, which is not fully convertible into foreign currencies. On January 1, 1994, the PRC government abolished the dual rate system and introduced a single rate of exchange as quoted by the People's Bank of China. However, the unification of the exchange rate does not imply convertibility of RMB into United States dollars or other foreign currencies. All foreign exchange transactions must take place either through the People's Bank of China or other institutions authorized to buy and sell foreign exchange or at a swap center. Approval of foreign currency payments by the People's Bank of China or other institutions requires submitting a payment application form together with suppliers' invoices, shipping documents and signed contracts.

*Interest rate risk*

The interest rates and terms of repayment of the Group's debts are disclosed in Note 12.

**28. RELATED PARTY TRANSACTIONS**



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Companies are considered to be related if one company has the ability, directly or indirectly, to control the other company or exercise significant influence over the other company in making financial and operating decisions. Companies are also considered to be related if they are subject to common control or common significant influence.

The Group conducts business with enterprises directly or indirectly owned or controlled by the PRC government ( state-owned enterprises ). Furthermore, the PRC government itself represents a significant customer of the Group both directly through its numerous authorities and indirectly through its numerous affiliates and other organizations. The Group considers that the provision of wireline telecommunications services to the PRC government authorities and affiliates and other state-owned enterprises are activities in the ordinary course of business in the PRC and has not disclosed such services as related party transactions.

The Group is part of a larger group of companies under China Telecom and has significant transactions and relationships with members of China Telecom. Because of these relationships, it is possible that the terms of these transactions are not the same as those that would result from transactions among wholly unrelated parties. Under IFRS, state-owned enterprises, other than China Telecom and its affiliates, are not disclosed as related parties. Related parties refer to enterprises over which China Telecom is able to exercise control or significant influence.

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**28. RELATED PARTY TRANSACTIONS (continued)**

The principal related party transactions with China Telecom Group, which were carried out in the ordinary course of business, are as follows:

	Note	Year ended December 31,		
		2002	2003	2004
		RMB	RMB	RMB
Purchases of telecommunications equipment and materials	(i)	1,599	573	304
Construction, engineering and information technology services	(ii)	7,668	7,999	6,568
Provision of community services	(iii)	2,284	2,563	2,417
Provision of ancillary services	(iv)	1,745	1,311	2,490
Provision of comprehensive services	(v)			361
Operating lease expenses	(vi)	441	353	393
Centralized service expenses	(vii)	483	369	163
Interconnection revenues	(viii)	302	253	98
Interconnection charges	(viii)	687	685	201
Interest on amounts due to and loans from China Telecom Group	(ix)			2,426

Note:

- (i) Represent purchases of telecommunications equipment and materials from China Telecom Group.
- (ii) Represent provision of network construction, engineering and information technology services to the Group by China Telecom Group.
- (iii) Represent amounts paid and payable by the Group to China Telecom Group in respect of cultural, educational, hygiene and other community services.
- (iv) Represent amounts paid and payable by the Group to China Telecom Group in respect of ancillary services such as repairs and maintenance of telecommunications equipment and facilities and certain customer services.
- (v) Represent amounts paid and payable by the Group to China Telecom Group in respect of comprehensive services provided (see scope of comprehensive services defined below).
- (vi)

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Represent amounts paid and payable to China Telecom Group for operating leases in respect of business premises and inter-provincial transmission optic fibers.

(vii) Represent net amount charged by China Telecom to the Group for costs associated with common corporate services and international telecommunications facilities.

(viii) Represent amounts charged from/to China Telecom for interconnection of domestic long distance telephone calls.

(ix) Represent interest paid and payable to China Telecom with respect to the deferred consideration payable to China Telecom in connection with the Acquisitions and interest with respect to loans from China Telecom Group (Note 12).

In connection with the Second Acquisition, the Group and China Telecom Group entered into a number of agreements on April 13, 2004. The principal terms of these agreements are similar to those disclosed in Note 28 to the Group's 2003 consolidated financial statements, other than an increase in the maximum commission rate for domestic equipment procurement from 1.8% to 3.0% to reflect the latest market price.

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**28. RELATED PARTY TRANSACTIONS (continued)**

In addition, the Company entered into a comprehensive services framework agreement with China Telecom on April 13, 2004 to govern the terms and conditions of transactions between the Group and entities within China Telecom Group which were not within the scope of the agreements entered into previously. Such transactions include procurement of telecommunications equipment, network design, software upgrade, system integration, manufacture of calling cards and other services. Pursuant to this agreement, China Telecom Group charges the Group for these services in accordance with the following terms:

government prescribed price;

where there is no government prescribed price but where there is a government guided price, the government guided price will apply;

where there is neither a government prescribed price nor a government guided price, the market price will apply;

where none of the above is available, the price is to be agreed between the relevant parties, which shall be based on the cost incurred in providing the services plus a reasonable profit margin.

The directors of the Company are of the opinion that the above transactions with related parties were conducted in the ordinary course of business and on normal commercial terms or in accordance with the agreements governing such transactions, and this has been confirmed by the independent non-executive directors.

**29. EMPLOYEE BENEFITS PLAN**

As stipulated by the regulations of the PRC, the Group participates in various defined contribution retirement plans organized by municipal and provincial governments for its employees. The Group is required to make contributions to the retirement plans at rates ranging from 18% to 20% of the salaries, bonuses and certain allowances of the employees. A member of the plan is entitled to a pension equal to a fixed proportion of the salary prevailing at the member's retirement date. The Group has no other material obligation for the payment of pension benefits associated with these plans beyond the annual contributions described above. The Group's contributions for the years ended December 31, 2002, 2003 and 2004 were RMB1,987, RMB1,996 and RMB2,031, respectively.

**30. STOCK APPRECIATION RIGHTS**

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The Company implemented a plan of stock appreciation rights for members of its senior management in order to provide further incentives to these employees. Under this plan, stock appreciation rights were granted in units with each unit representing one H share. No shares will be issued under the stock appreciation rights plan.

Under the plan, all stock appreciation rights will have an exercise period of six years. A recipient of stock appreciation rights may not exercise the rights in the first 18 months after the date of grant. As at each of the third, fourth, fifth and sixth anniversary of the date of grant, the total number of stock appreciation rights exercisable may not in aggregate exceed 25%, 50%, 75% and 100%, respectively, of the total stock appreciation rights granted to such person.

In March 2003, the Company's compensation committee approved the plan for stock appreciation rights pursuant to which the Company granted 276 million stock appreciation right units to eligible employees during 2003.

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**30. STOCK APPRECIATION RIGHTS (continued)**

The exercise price of stock appreciation rights granted in 2003 is the initial public offering price of the Company's H shares. Upon exercise of the stock appreciation rights, a recipient will receive, subject to any applicable withholding tax, a cash payment in RMB, translated from the Hong Kong dollar amount equal to the product of the number of stock appreciation rights exercised and the difference between the exercise price and market price of the Company's H shares at the date of exercise based on the applicable exchange rate between RMB and Hong Kong dollar at the date of the exercise.

During the year ended December 31, 2004, 70 million stock appreciation right units were exercised. No stock appreciation right units were exercised in the year ended December 31, 2003.

The Company recognizes compensation expense of the stock appreciation rights over the applicable vesting period. For the years ended December 31, 2003 and 2004, compensation expense recognized was RMB97 and RMB70, respectively.

**31. PRINCIPAL SUBSIDIARIES**

Details of the Company's subsidiaries as of December 31, 2004, which principally affected the results of operations and the financial position of the Group, are as follows:

<u>Name of Company</u>	<u>Type of legal entity</u>	<u>Date of incorporation</u>	<u>Registered capital (RMB)</u>
Shanghai Telecom Company Limited	Limited company	October 11, 2002	15,984
Guangdong Telecom Company Limited	Limited company	October 10, 2002	47,513
Jiangsu Telecom Company Limited	Limited company	October 19, 2002	19,208
Zhejiang Telecom Company Limited	Limited company	October 10, 2002	22,400
Anhui Telecom Company Limited	Limited company	August 26, 2003	3,871
Fujian Telecom Company Limited	Limited company	August 28, 2003	10,364
Jiangxi Telecom Company Limited	Limited company	September 18, 2003	1,153
Guangxi Telecom Company Limited	Limited company	August 28, 2003	4,992
Chongqing Telecom Company Limited	Limited company	August 22, 2003	4,276
Sichuan Telecom Company Limited	Limited company	August 28, 2003	8,123
Hubei Telecom Company Limited	Limited company	March 9, 2004	5,412
Hunan Telecom Company Limited	Limited company	March 12, 2004	661
Hainan Telecom Company Limited	Limited company	March 9, 2004	580
Guizhou Telecom Company Limited	Limited company	March 12, 2004	2,401

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Yunnan Telecom Company Limited	Limited company	March 9, 2004	3,747
Shaanxi Telecom Company Limited	Limited company	March 8, 2004	2,482
Gansu Telecom Company Limited	Limited company	March 10, 2004	3,413
Qinghai Telecom Company Limited	Limited company	March 10, 2004	965
Ningxia Telecom Company Limited	Limited company	March 10, 2004	795
Xinjiang Telecom Company Limited	Limited company	March 11, 2004	4,660

All of the above subsidiaries are incorporated in the PRC, are wholly-owned by the Company and are engaged in provision of telecommunications services.

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**32. FAIR VALUES OF FINANCIAL INSTRUMENTS**

Financial assets of the Group include cash and cash equivalents, time deposits, investments, accounts receivable, amounts due from China Telecom Group, advances and other receivables. Financial liabilities of the Group include debts, accounts payable, amounts due to China Telecom Group, accrued expenses and other payables. The Group does not hold nor issue financial instruments for trading purposes.

The disclosures of the fair value estimates, methods and assumptions set forth below for the Group's financial instruments are made to comply with the requirements of IAS 32 and IAS 39, and should be read in conjunction with the Group's consolidated financial statements and related notes. The estimated fair value amounts have been determined by the Group using market information and valuation methodologies considered appropriate. However, considerable judgment is required to interpret market data to develop the estimates of fair values. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Group could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

The following summarizes the major methods and assumptions used in estimating the fair values of the Group's financial instruments.

Long-term debt: The fair values of long-term indebtedness are estimated by discounting future cash flows using current market interest rates offered to the Group for debt with substantially the same characteristics and maturities. As of December 31, 2003 and 2004, the carrying amounts and fair values of the Group's long-term debt were as follows:

	December 31, 2003		December 31, 2004	
	Carrying amount	Fair value	Carrying amount	Fair value
	RMB	RMB	RMB	RMB
Long-term debt	82,589	83,070	84,208	82,850

The Group's long-term investments are unlisted equity interests and there are no quoted market prices for such interests in the PRC. Accordingly, a reasonable estimate of their fair values could not be made without incurring excessive costs.

The fair values of all other financial instruments approximate their carrying amounts due to the short-term maturity of these instruments.



### **33. SIGNIFICANT DIFFERENCES BETWEEN IFRS AND US GAAP**

The Group's accounting policies conform with IFRS which differ in certain significant respects from US GAAP. The significant differences are set out below.

#### **(a) Revaluation of property, plant and equipment**

In connection with the Restructuring, the property, plant and equipment of the Predecessor Operations were revalued as of December 31, 2001 (Note 7). The net revaluation deficit has been reflected in the consolidated financial statements as of December 31, 2001. Such revaluation resulted in an increase directly to shareholders' equity of RMB4,154 with respect to the increase in carrying amount of certain property, plant and equipment above their historical cost bases, and a charge to income of RMB11,930 with respect to the reduction in carrying amount of certain property, plant and equipment below their historical cost bases.

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**33. SIGNIFICANT DIFFERENCES BETWEEN IFRS AND US GAAP (continued)**

**(a) Revaluation of property, plant and equipment (continued)**

In connection with the First Acquisition, the property, plant and equipment of the First Acquired Group were revalued as of December 31, 2002 (Note 7). The net revaluation deficit has been reflected in the consolidated financial statements as of December 31, 2002. Such revaluation resulted in an increase directly to shareholders' equity of RMB760 with respect to the increase in carrying amount of certain property, plant and equipment above their historical cost bases, and a charge to income of RMB14,690 with respect to the reduction in carrying amount of certain property, plant and equipment below their historical cost bases.

In connection with the Second Acquisition, the property, plant and equipment of the Second Acquired Group were revalued as of December 31, 2003. The net revaluation deficit has been reflected in the consolidated financial statements as of December 31, 2003. Such revaluation resulted in an increase directly to shareholders' equity of RMB1,537 with respect to the increase in carrying amount of certain property, plant and equipment above their historical cost bases, and a charge to income of RMB14,832 with respect to the reduction in carrying amount of certain property, plant and equipment below their historical cost bases.

In accordance with Group's accounting policy, the property, plant and equipment of the Group were revalued as of December 31, 2004. The net revaluation deficit has been reflected in the consolidated financial statements as of December 31, 2004. Such revaluation resulted in an increase directly to shareholders' equity of RMB1,233 with respect to the increase in carrying amount of certain property, plant and equipment above their historical cost bases, and a charge to income of RMB1,262 with respect to the reduction in carrying amount of certain property, plant and equipment below their historical cost bases.

Under US GAAP, property, plant and equipment are stated at their historical cost less accumulated depreciation unless an impairment loss has been recorded. An impairment loss on property, plant and equipment is recorded under US GAAP if the carrying amount of such asset exceeds its future undiscounted cash flows resulting from the use of the asset and its eventual disposition. The future undiscounted cash flows of the Group's property, plant and equipment, whose carrying amount was reduced as a result of the above revaluations, exceed the historical cost carrying amount of such property, plant and equipment and, therefore, impairment of such assets is not appropriate under US GAAP. Accordingly, the revaluation reserves recorded directly to shareholders' equity and the charges to income recorded under IFRS as a result of the above revaluations are reversed for US GAAP purposes.

However, as a result of the tax deductibility of the net revaluation deficit, a deferred tax liability related to the net revaluation deficit is created under US GAAP with a corresponding decrease in shareholders' equity.

**(b) Disposal of revalued property, plant and equipment**

Under IFRS, on disposal of a revalued asset, the related revaluation surplus is transferred from the revaluation reserve to retained earnings. Under US GAAP, the gain and loss on disposal of an asset is determined with reference to the asset's historical cost carrying amount and included in current earnings.

**(c) Effect of change in tax rate**

Under IFRS, the effect of a change in tax rate that results in a change in the carrying amounts of deferred tax assets and liabilities is charged or credited directly to equity, to the extent that such deferred tax assets and liabilities are previously charged or credited to equity. Under US GAAP, the effect of a change in tax rate for all items of deferred tax assets and liabilities is recorded in the income statement.

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(All amounts in millions, except per share data)

**33. SIGNIFICANT DIFFERENCES BETWEEN IFRS AND US GAAP (Continued)****(d) Related party transactions**

Under IFRS, transactions with state-controlled enterprises other than China Telecom and its affiliates are not required to be disclosed as related party transactions. Furthermore, government departments and agencies are deemed not to be related parties to the extent that such transactions are in the normal course of business. Therefore, related party transactions as disclosed in Note 28 only refer to transactions with China Telecom Group.

Under US GAAP, there are no similar exemptions. The Group's principal transactions with state-controlled telecommunications operators in the PRC were as follows:

	<u>Year ended December 31,</u>		
	<u>2002</u>	<u>2003</u>	<u>2004</u>
	<u>RMB</u>	<u>RMB</u>	<u>RMB</u>
Interconnection revenues	5,570	6,931	8,964
Interconnection charges	955	1,154	2,190
Leased line revenues	4,489	3,476	2,701

The amounts set out above represent the historical costs incurred by the related parties in carrying out such transactions.

**(e) Recently issued accounting standards.****SFAS No. 123R**

In December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-based payment (SFAS No. 123R). SFAS No. 123R addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for equity instruments of the enterprise or liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. SFAS No. 123R requires an entity to recognize the grant-date fair-value of stock options and other equity-based compensation

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issued to employees in the income statement. SFAS No. 123R generally requires that an entity account for those transactions using the fair-value-based method, and eliminates an entity's ability to account for share-based compensation transactions using the intrinsic value method of accounting, which was permitted under Statement 123, as originally issued. For the Group, SFAS No. 123R is effective at the beginning of the reporting period that begins after June 15, 2005. Currently, the Group does not expect the application of SFAS No. 123R will have a material impact on its consolidated financial statements.

### **SFAS No. 151**

In November 2004, the FASB issued SFAS No. 151, *Inventory costs*. SFAS No. 151 clarifies accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). SFAS No. 151 requires that those items be recognized as current period charges. Additionally, SFAS No. 151 requires that allocation of fixed production overheads to the costs of conversion based on normal capacity of the production facilities. For the Group, SFAS No. 151 is effective for fiscal years beginning after June 15, 2005. Currently, the Group does not expect the application of SFAS No. 151 will have a material impact on its consolidated financial statements.

### **SFAS No. 152**

In December 2004, the FASB issued SFAS No. 152, *Accounting for Real Estate Time-Sharing Transactions*. SFAS No. 152 amends SFAS No. 66, *Accounting for Sales of Real Estate* to reference accounting and reporting guidance for real estate time-sharing transactions. SFAS No. 152 amends SFAS No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, so that the guidance in SFAS No. 67 about incidental operations and costs incurred to sell real estate projects does not apply to real-estate time-sharing transactions. For the Group, SFAS No. 152 is effective for fiscal years beginning after June 15, 2005. Currently, the Group does not expect the application of SFAS No. 152 will have a material impact on its consolidated financial statements.

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(All amounts in millions, except per share data)

**33. SIGNIFICANT DIFFERENCES BETWEEN IFRS AND US GAAP (Continued)****(e) Recently issued accounting standards (continued)****SFAS No. 153**

In December 2004, the FASB issued SFAS No. 153, Exchanges of Non-monetary Assets. SFAS No. 153 addresses the accounting for non-monetary exchanges of productive assets. SFAS No. 153 requires non-monetary exchanges to be accounted for at fair value, recognizing any gains or losses, if the fair value is determinable within reasonable limits and the transaction has commercial substance. For the Group, SFAS No. 153 is effective for fiscal years beginning after June 15, 2005. Currently, the Group does not expect the application of SFAS No. 153 will have a material impact on its consolidated financial statements.

**(f) Reconciliation of net income and shareholders' equity under IFRS to US GAAP**

The effect on net income of significant differences between IFRS and US GAAP for the years ended December 31, 2002, 2003 and 2004 is as follows:

	Year ended December 31,			
	2002	2003	2004	2004
	RMB	RMB	RMB	US\$
Net income under IFRS	8,219	13,882	28,023	3,386
US GAAP adjustments:				
Reversal of deficit on revaluation of property, plant and equipment	14,690	14,832	1,262	152
Depreciation on revalued property, plant and equipment, net of minority interests	(1,542)	(3,940)	(6,766)	(817)
Disposal of revalued property, plant and equipment	(55)	(60)	(128)	(16)
Effect of change in tax rate on deferred tax assets arising from revaluation of land use rights			(244)	(29)
Effect of change in tax rate on deferred tax liabilities arising from revaluation of property, plant and equipment			2,189	264
Deferred tax effect of US GAAP adjustments	(4,321)	(3,262)	1,379	167
Net income under US GAAP	16,991	21,452	25,715	3,107

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Basic earnings per share under US GAAP	0.25	0.28	0.33	0.04
Basic earnings per ADS* under US GAAP	24.54	28.37	32.62	3.94

\* Basic earnings per ADS is calculated on the basis that one ADS is equivalent to 100 H shares.

The effect on shareholders' equity of significant differences between IFRS and US GAAP as of December 31, 2003 and 2004 is as follows:

	December 31,		
	2003	2004	2004
	RMB	RMB	US\$
Shareholders' equity under IFRS	150,794	159,206	19,236
US GAAP adjustments:			
Revaluation of property, plant and equipment, net of minority interests	29,312	22,447	2,712
Deferred tax effect of US GAAP adjustment	(9,465)	(5,519)	(667)
Shareholders' equity under US GAAP	170,641	176,134	21,281

**Table of Contents****Exhibit Index**

<b>Exhibits</b>	<b>Description</b>
1.1	Articles of Association (as amended) (English translation).
2.1	Form of H Share Certificate. <sup>(1)</sup>
2.2	Form of Deposit Agreement among the Registrant, The Bank of New York, as depository, and Owners and Beneficial Owners from time to time of American Depositary Shares evidenced by American Depositary Receipts issued thereunder, including the form of American Depositary Receipt. <sup>(2)</sup>
4.1	Supplemental Trademark License Agreement, dated October 26, 2003, between the Registrant and China Telecom Group (English translation). <sup>(3)</sup>
4.2	Sale and Purchase Agreement, dated October 26, 2003, between the Registrant and China Telecom Group (English translation). <sup>(3)</sup>
4.3	Supplemental Connected Transactions Agreement, dated October 26, 2003, between the Registrant and China Telecom Group (English translation). <sup>(3)</sup>
4.4	Form of Underwriting Agreement. <sup>(4)</sup>
4.5	Supplemental Trademark License Agreement, dated April 13, 2004, between the Registrant and China Telecom Group (English translation). <sup>(5)</sup>
4.6	Supplemental Connected Transactions Agreement, dated April 13, 2004, between the Registrant and China Telecom Group (English translation). <sup>(6)</sup>
4.7	Comprehensive Services Agreement, dated April 13, 2004, between the Registrant and China Telecom Group (English translation). <sup>(7)</sup>
4.8	Conditional Sale and Purchase Agreement, dated April 13, 2004, between the Registrant and China Telecom Group (English translation). <sup>(8)</sup>
4.9	Supplemental Conditional Sale and Purchase Agreement, dated June 9, 2005, between the Registrant and China Telecom Group (English summary)
8.1	List of subsidiaries of the Registrant.
11.1	Code of Ethics (English translation). <sup>(3)</sup>
12.1	Certification of CEO pursuant to Rule 13a-14(a).
12.2	Certification of CFO pursuant to Rule 13a-14(a).
13.1	Certification of CEO pursuant to Rule 13a-14(b).
13.2	Certification of CFO pursuant to Rule 13a-14(b).
14.1	Consent of KPMG.

(1) Incorporated by reference to our Registration Statement on Form F-1 (File No. 333-100042), filed with the Securities and Exchange Commission on November 5, 2002.



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- (2) Incorporated by reference to our Registration Statement on Form F-6 (File No. 333-100617), filed with the Securities and Exchange Commission with respect to American Depositary Shares representing our H shares.
- (3) Incorporated by reference to our Annual Report on Form 20-F for the fiscal year ended December 31, 2003 (File No. 001-31517), filed with the Securities and Exchange Commission.
- (4) Incorporated by reference to Exhibit 1.1 to our Form 6-K filed on April 29, 2004
- (5) Incorporated by reference to Exhibit 1.2 to our Form 6-K filed on April 29, 2004.
- (6) Incorporated by reference to Exhibit 1.3 to our Form 6-K filed on April 29, 2004.
- (7) Incorporated by reference to Exhibit 1.4 to our Form 6-K filed on April 29, 2004.
- (8) Incorporated by reference to Exhibit 1.5 to our Form 6-K filed on April 29, 2004.