

CHINA UNICOM LTD  
Form 20-F  
June 29, 2006

# SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

## FORM 20-F

- 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, 2005**

OR

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

**For the transition period from                      to /**

OR

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

**Date of event requiring this shell company report**

**Commission file number 1-15028**

## CHINA UNICOM LIMITED

(Exact Name of Registrant as Specified in Its Charter)

**N/A**

(Translation of Registrant's Name Into English)

**Hong Kong**

(Jurisdiction of Incorporation or Organization)

**75th Floor, The Center**

**99 Queen's Road Central**

**Hong Kong**

(Address of Principal Executive Offices)

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

**Title of Each Class**

Ordinary shares, par value HK\$0.10 per share

**Name of Each Exchange On Which Registered**

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, or ADSs, each representing 10 ordinary shares.

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

**None**

(Title of class)

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

**None**  
(Title of Class)

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, 2005, 12,574,265,270 ordinary shares were issued and outstanding.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. Yes  No

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 whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

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

Item 17  Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

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**NOTE REGARDING FORWARD-LOOKING STATEMENTS**

This annual report for the year ended December 31, 2005 contains forward-looking statements that are, by their nature, subject to significant risks and uncertainties. Such forward-looking statements include, without limitation:

- our strategy and future plan,
- our capital expenditure plan,
- our future business condition and financial results,
- our abilities to upgrade and expand our networks and increase network efficiency,
- our ability to improve our existing services and offer and market new services,
- our ability to leverage our position as an integrated telecommunications operator and expand into new businesses and new markets,
- future growth of market demand for our services,
- our ability to upgrade and develop technology applications, and
- future regulatory and other developments in the Chinese telecommunications industry.

These forward-looking statements reflect our current views with respect to future events. Actual results may differ materially from information contained in the forward-looking statements as a result of a number of factors that may be beyond our control, including, without limitation:

- any changes in the regulatory policies of the Ministry of Information Industry, or MII, the State-owned Assets Supervision and Administration Commission, or SASAC, and other relevant government authorities in the People's Republic of China, or the PRC,
- the PRC government's decision in relation to the technology standards and licenses of third generation mobile telecommunication, or 3G,
- the effects of competition on the demand and price of our telecommunications services,
- any changes in telecommunications and related technology and applications based on such technology, and
- changes in political, economic, legal and social conditions in China including: the PRC government's policies with respect to economic growth, consolidations of and other structural changes in the PRC telecommunications industry, foreign exchange, foreign investment and entry by foreign companies into China's telecommunications market.

In addition, our future capital expenditure and development plans are dependent on various factors, including, among others:

- the availability of adequate financing on acceptable terms,



- the adequate and timely supply of equipment when required, and
- the adequacy of currently available spectrum or availability of additional spectrum.

Please also see the D. Risk Factors section under Item 3.

#### **CERTAIN DEFINITIONS**

As used in this annual report, references to we, us, our, the Company and Unicom are to China Unicom Limited. Unless the context otherwise requires, these references include all of our subsidiaries. In respect of any time prior to our incorporation, references to we, us, our and Unicom are to the telecommunications businesses in which our predecessors were engaged and which were subsequently assumed by us. All references to Unicom Group are to China United Telecommunications Corporation, our indirect controlling shareholder. Unless the context otherwise requires, these references include all of Unicom Group's subsidiaries, including us and our subsidiaries. Please also see A. History and Development of the Company under Item 4 for our current shareholding structure.

**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 consolidated income statement data for the years ended December 31, 2001, 2002, 2003, 2004 and 2005 and our selected consolidated balance sheet data as of December 31, 2001, 2002, 2003, 2004 and 2005. The selected consolidated balance sheet data as of December 31, 2004 and 2005 and income statement and cash flow data for the years ended December 31, 2003, 2004 and 2005 have been derived from our audited consolidated financial statements included in this annual report. The selected consolidated balance sheet data as of December 31, 2001, 2002 and 2003 and income statement and cash flow data for the years ended December 31, 2001 and 2002 have been derived from our audited consolidated financial statements that are not included in this annual report.

Our financial statements are prepared in accordance with Hong Kong Financial Reporting Standards and Hong Kong Accounting Standards, or HKFRS, which became effective on January 1, 2005. Prior to January 1, 2005, our financial statements were prepared in accordance with generally accepted accounting principles in Hong Kong, or HK GAAP. The adoption of HKFRS resulted in changes in certain accounting policies which have been reflected in the financial statements either in accordance with the transitional provisions in the applicable accounting standards or, to the extent there are no transitional provisions, applied retrospectively. Accordingly, the comparative financial data presented in this annual report for the years ended December 31, 2001, 2002, 2003 and 2004 have been restated, as applicable, to conform to the changed accounting policies. A detailed description is set forth in Note 2.2 to our consolidated financial statements.

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Financial statements prepared in accordance with HKFRS vary in certain material respects from generally accepted accounting principles in the United States, or US GAAP. In accordance with HKFRS, we adopted the purchase method to account for our acquisitions from Unicom Group of certain cellular businesses and assets held by Unicom New Century Telecommunications Corporation Limited, or Unicom New Century, Unicom New World Telecommunications Corporation Limited, or Unicom New World, and China Unicom International Limited, or Unicom International. The acquisitions of Unicom New Century, Unicom New World and Unicom International became effective on December 31, 2002, December 31, 2003 and in September 2004, respectively, as described in A. History and Development of the Company under Item 4. Accordingly, our consolidated income statement and, except as otherwise noted, all other HKFRS financial information for the year 2004 presented in this annual report include the operating results of Unicom New Century and Unicom New World for the year ended December 31, 2004 and the operating results of Unicom International from the effective date of the acquisition to December 31, 2004, but our consolidated income statement and all other HKFRS financial information for the year 2003 presented in this annual report do not include the operating results of Unicom New World for the year ended December 31, 2003. Under the purchase method, our consolidated balance sheet as of December 31, 2003 includes the financial position of Unicom New Century and Unicom New World and our consolidated balance sheet as of December 31, 2004 also includes the financial position of Unicom International. In contrast, under US GAAP, these acquisitions would have been accounted for as transfers of entities under common control. The financial statements prepared under US GAAP would have been retroactively restated for all periods presented on a combined basis as if the acquisitions had been in effect since inception, whereby related assets and liabilities of the acquired businesses would have been accounted for at historical cost and the results of operations of the acquired businesses would have been included in the consolidated financial statements for the earliest period presented.

Under HKFRS, the sale of Guoxin Paging Corporation Ltd., or Guoxin Paging, on December 31, 2003 by us to Unicom Group has been accounted for as a sale of discontinued operation. The difference between the sale proceeds and the carrying amount of net assets of Guoxin Paging as of December 31, 2003 was recorded as the loss on sale of discontinued operation in our consolidated income statement for the year ended December 31, 2003. The operating results of Guoxin Paging from January 1, 2003 to the effective date of the sale of Guoxin Paging were included in our consolidated income statement for the year ended December 31, 2003. Under US GAAP, the sale of Guoxin Paging to Unicom Group is considered a transfer of business between entities under common control and accounted for at historical cost of the net assets transferred, after reduction, if appropriate, for an indicated impairment of value. In addition, under US GAAP, the results of operations of a component or segment of an entity that has been disposed of should be reported in discontinued operations as a separate component of income, separated from continuing operations, in the period in which the disposal occurred and in prior periods. Accordingly, all the operating results of Guoxin Paging have been grouped into and reported in the income statement as Discontinued operation - Loss from discontinued operation under US GAAP.

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See Note 37 to the consolidated financial statements included in this annual report for a summary of the principal differences between HKFRS and US GAAP that have a significant effect on our financial statements.

|   | As of or for the year ended December 31 |   |               |   |               |   |            |               |            |            |         |
|---|---|---|---------------|---|---------------|---|------------|---------------|------------|------------|---------|
|   | 2001                                    |   | 2002          |   | 2003          |   |            | 2004          |            | 2005       |         |
|   | (Restated)(1)                           |   | (Restated)(1) |   | (Restated)(1) |   |            | (Restated)(1) |            | 2005       | 2005    |
|   | RMB                                     |   | RMB           |   | RMB           |   |            | RMB           |            | RMB        | US\$(2) |
| (in millions, except number of shares and per share data)   |   |   |               |   |               |   |            |               |            |            |         |
| <b>Income Statement Data:</b>   |   |   |               |   |               |   |            |               |            |            |         |
| HKFRS   |   |   |               |   |               |   |            |               |            |            |         |
| Revenue (Turnover):   |   |   |               |   |               |   |            |               |            |            |         |
| Cellular Business   | 20,640                                  |   | 31,112        |   | 57,819        |   | 71,887     |               | 79,712     | 9,877      |         |
| -GSM Business   | 20,640                                  |   | 27,890        |   | 41,153        |   | 47,509     |               | 52,136     | 6,460      |         |
| -CDMA Business  |   |   | 3,222         |   | 16,667        |   | 24,378     |               | 27,577     | 3,417      |         |
| Paging Business   | 4,342                                   |   | 2,161         |   | 1,403         |   |            |               |            |            |         |
| Long Distance Business  | 1,489                                   |   | 2,766         |   | 2,273         |   | 1,848      |               | 1,525      | 189        |         |
| Data and Internet Business  | 1,820                                   |   | 2,793         |   | 3,437         |   | 3,663      |               | 3,050      | 378        |         |
| Total service revenue   | 28,291                                  |   | 38,832        |   | 64,933        |   | 77,397     |               | 84,287     | 10,444     |         |
| Sales of telecommunications Products  | 556                                     |   | 1,411         |   | 2,221         |   | 1,690      |               | 2,762      | 342        |         |
| Total revenue   | 28,847                                  |   | 40,243        |   | 67,154        |   | 79,087     |               | 87,049     | 10,786     |         |
| Costs and expenses  | (23,554)                                | ) | (32,912)      | ) | (58,538)      | ) | (71,127)   | )             | (78,979)   | (9,786)    |         |
| Income before income tax  | 5,493                                   |   | 6,311         |   | 6,198         |   | 6,471      |               | 7,102      | 880        |         |
| Net income  | 4,660                                   |   | 4,649         |   | 4,269         |   | 4,493      |               | 4,931      | 611        |         |
| -Basic net income per share(3)  | 0.37                                    |   | 0.37          |   | 0.34          |   | 0.36       |               | 0.39       | 0.05       |         |
| -Number of shares outstanding for basic net income per share (in thousands)(3)  | 12,552,996                              |   | 12,552,996    |   | 12,553,010    |   | 12,561,242 |               | 12,570,398 | 12,570,398 |         |
| -Diluted net income per share(3)  | 0.37                                    |   | 0.37          |   | 0.34          |   | 0.36       |               | 0.39       | 0.05       |         |
| -Number of shares outstanding for diluted net income per share (in thousands)(3)  | 12,552,996                              |   | 12,552,996    |   | 12,556,728    |   | 12,593,054 |               | 12,607,476 | 12,607,476 |         |
| -Basic net income per ADS(4)  | 3.68                                    |   | 3.69          |   | 3.41          |   | 3.58       |               | 3.92       | 0.49       |         |
| -Number of ADS outstanding for basic net income per ADS (in thousands)(3)   | 1,255,300                               |   | 1,255,300     |   | 1,255,301     |   | 1,256,124  |               | 1,257,040  | 1,257,040  |         |
| -Diluted net income per ADS(4)  | 3.68                                    |   | 3.69          |   | 3.41          |   | 3.57       |               | 3.91       | 0.48       |         |
| -Number of ADS outstanding for diluted net income per ADS (in thousands)(3)   | 1,255,300                               |   | 1,255,300     |   | 1,255,673     |   | 1,259,305  |               | 1,260,748  | 1,260,748  |         |
| US GAAP(5)  |   |   |               |   |               |   |            |               |            |            |         |
| Revenue   | 32,501                                  |   | 50,421        |   | 71,980        |   | 79,388     |               | 87,255     | 10,812     |         |
| Operating income from continuing operations   | 7,921                                   |   | 9,759         |   | 10,710        |   | 8,185      |               | 8,142      | 1,009      |         |
| Net income before discontinued operation, and cumulative effect of change in accounting policy                                  | 5,866                                   |   | 5,500         |   | 6,078         |   | 4,713      |               | 5,013      | 621        |         |
| Loss from discontinued operation, net of tax  | 710                                     |   | 422           |   | 1,342         |   |            |               |            |            |         |
| Cumulative effect of change in accounting policy (transitional adjustment of goodwill impairment upon the adoption of SFAS 142) |   |   | 42            |   |               |   |            |               |            |            |         |
| Net income  | 5,155                                   |   | 5,036         |   | 4,736         |   | 4,713      |               | 5,013      | 621        |         |
| -Basic net income per share before discontinued operation and cumulative effect of change in                                    | 0.47                                    |   | 0.44          |   | 0.48          |   | 0.38       |               | 0.40       | 0.05       |         |

accounting policy(3)

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|  | As of or for the year ended December 31                   |   |                       |   |                       |   |                       |   |          |         |
|--|---|---|-----------------------|---|-----------------------|---|-----------------------|---|----------|---------|
|  | 2001<br>(Restated)(1)                                     |   | 2002<br>(Restated)(1) |   | 2003<br>(Restated)(1) |   | 2004<br>(Restated)(1) |   | 2005     | 2005    |
|  | RMB   |   | RMB                   |   | RMB                   |   | RMB                   |   | RMB      | US\$(2) |
|  | (in millions, except number of shares and per share data) |   |                       |   |                       |   |                       |   |          |         |
| -Basic net income per ADS before discontinued operation and cumulative effect of change in accounting policy(4)  | 4.67  |   | 4.38                  |   | 4.84                  |   | 3.75                  |   | 3.99     | 0.49    |
| -Basic net income per share after discontinued operation and cumulative effect of change in accounting policy(3) | 0.41  |   | 0.40                  |   | 0.38                  |   | 0.38                  |   | 0.40     | 0.05    |
| -Basic net income per ADS after discontinued operation and cumulative effect of change in accounting policy(4)   | 4.11  |   | 4.01                  |   | 3.77                  |   | 3.75                  |   | 3.97     | 0.49    |
| <b>Balance sheet Data:</b>   |   |   |                       |   |                       |   |                       |   |          |         |
| <b>HKFRS</b>   |   |   |                       |   |                       |   |                       |   |          |         |
| Bank balances and cash   | 18,413  |   | 14,433                |   | 9,220                 |   | 4,655                 |   | 5,472    | 678     |
| Property, plant and equipment  | 75,493  |   | 107,216               |   | 117,863               |   | 118,492               |   | 116,056  | 14,381  |
| Total assets   | 130,118   |   | 152,095               |   | 152,870               |   | 149,038               |   | 142,630  | 17,674  |
| Short-term debt and current portion of other long-term debt  | 7,933   |   | 15,330                |   | 18,173                |   | 20,015                |   | 22,035   | 2,730   |
| Obligations under finance lease-current portion  | 8   |   | 17                    |   | 25                    |   | 938                   |   | 421      | 52      |
| Obligations under finance lease-non-current portion  | 101   |   | 101                   |   | 100                   |   | 489                   |   | 145      | 18      |
| Other long-term debt   | 36,337  |   | 37,686                |   | 36,213                |   | 26,137                |   | 11,982   | 1,485   |
| Shareholders' equity   | 61,943  |   | 66,572                |   | 69,052                |   | 72,442                |   | 76,287   | 9,453   |
| <b>US GAAP (Restated)(5)</b>   |   |   |                       |   |                       |   |                       |   |          |         |
| Property, plant and equipment  |   |   | 118,787               |   | 118,171               |   | 118,701               |   | 116,232  | 14,403  |
| Total assets   |   |   | 164,636               |   | 150,477               |   | 146,615               |   | 139,958  | 17,343  |
| Obligations under finance lease-current portion  |   |   | 17                    |   | 25                    |   | 938                   |   | 421      | 52      |
| Obligations under finance lease-non-current portion  |   |   | 101                   |   | 100                   |   | 489                   |   | 145      | 18      |
| Other long-term debt   |   |   | 45,520                |   | 36,213                |   | 26,137                |   | 11,982   | 1,485   |
| Shareholders' equity   |   |   | 64,215                |   | 65,946                |   | 69,442                |   | 73,265   | 9,078   |
| <b>Other Financial Data:</b>   |   |   |                       |   |                       |   |                       |   |          |         |
| <b>HKFRS:</b>  |   |   |                       |   |                       |   |                       |   |          |         |
| Net cash provided by operating activities  | 11,078  |   | 13,054                |   | 22,565                |   | 23,819                |   | 30,804   | 3,817   |
| Net cash used in investing activities  | (46,125)  | ) | (5,166)               | ) | (19,051)              | ) | (18,958)              | ) | (16,748) | (2,075) |
| Net cash provided by (used in) financing activities  | 8,743   |   | (11,868)              | ) | (8,778)               | ) | (9,401)               | ) | (13,213) | (1,637) |
| <b>US GAAP (Restated)(5):</b>  |   |   |                       |   |                       |   |                       |   |          |         |
| Net cash provided by operating activities  | 15,320  |   | 18,235                |   | 25,993                |   | 24,510                |   | 31,486   | 3,902   |
| Net cash used in investing activities  | (62,971)  | ) | (10,261)              | ) | (20,295)              | ) | (19,668)              | ) | (17,431) | (2,160) |



|   | As of or for the year ended December 31                   |                       |                       |                       |          |         |  |  |
|---|---|-----------------------|-----------------------|-----------------------|----------|---------|--|--|
|   | 2001<br>(Restated)(1)                                     | 2002<br>(Restated)(1) | 2003<br>(Restated)(1) | 2004<br>(Restated)(1) | 2005     | 2005    |  |  |
|   | RMB   | RMB                   | RMB                   | RMB                   | RMB      | US\$(2) |  |  |
|   | (in millions, except number of shares and per share data) |                       |                       |                       |          |         |  |  |
| Net cash provided by (used in) financing activities | 21,015  | (12,773)              | (11,397)              | (9,440)               | (13,213) | (1,637) |  |  |

(1) The adoption of HKFRS on January 1, 2005 resulted in changes in certain accounting policies which have been reflected in the financial statements either in accordance with the transitional provisions in the applicable accounting standards or, to the extent there are no transitional provisions, applied retrospectively. Accordingly, the comparative financial data prior to January 1, 2005 presented herein have been restated, as applicable, to conform to the changed accounting policies. See Note 2.2 to our consolidated financial statements included in this Form 20-F for detailed discussion.

(2) The translation of RMB into US dollars has been made at the rate of RMB8.0702 to US\$1.00, the noon buying rate in New York City for cable transfer in RMB as certified for customs purposes by the Federal Reserve Bank of New York on December 30, 2005. The translations are solely for the convenience of the reader.

(3) See Notes 29 and 37 to the financial statements included in this Form 20-F on how basic and diluted net income per share are calculated under HKFRS and US GAAP, respectively.

(4) Net income per ADS is calculated by multiplying net income per share by 10, which is the number of shares represented by each ADS.

(5) The US GAAP amounts as of and for each of the relevant years ended on December 31, 2005, 2004, 2003 and 2002 are presented as if the acquisitions of Unicom New Century, Unicom New World and Unicom International had been in existence since the beginning of the earliest period presented.

#### Historical Exchange Rates Information

We publish our financial statements in Renminbi, or RMB, the legal tender currency in the PRC. In this annual report, references to US dollars or US\$ are to United States dollars and references to Hong Kong dollars, HK dollars or HK\$ are to Hong Kong dollars. Solely for the convenience of the reader, this annual report contains translations of certain RMB and Hong Kong dollar amounts into US dollar amounts and vice versa at specified rates. These translations should not be construed as representations that the RMB or Hong Kong dollar amounts actually represent such US dollar amounts or could be converted into US dollar amounts at the rates indicated or at all. Unless otherwise stated, the translations of RMB and Hong Kong dollars into US dollars and vice versa have been made at the rate of RMB8.0702 to US\$1.00 and HK\$7.7533 to US\$1.00, the noon buying rates in New York City for cable transfers payable in RMB or Hong Kong dollars as certified for customs purposes by the Federal Reserve Bank of New York on December 30, 2005.

The noon buying rates on June 28, 2006 were RMB7.9970 to US\$1.00 and HK\$7.7678 to US\$1.00, respectively. The average noon buying rates for 2001, 2002, 2003, 2004 and 2005 were RMB8.2772, RMB8.2771, RMB8.2772, RMB8.2768 and RMB8.1826, respectively, to US\$1.00, and HK\$7.7996, HK\$7.7996, HK\$7.7864, HK\$7.7899 and HK\$7.7755, respectively, to US\$1.00, calculated as the average of the noon buying rates on the last day of each month during each applicable year. The following table sets forth the high and low noon buying rates between RMB and the US dollar (in RMB per US dollar) and Hong Kong dollar and the US dollar (in Hong Kong dollar per US dollar) for each month during the previous six months:

| Period        | High<br>(RMB per US\$1.00) | Low<br>(RMB per US\$1.00) | High<br>(HK\$ per US\$1.00) | Low<br>(HK\$ per US\$1.00) |
|---------------|----------------------------|---------------------------|-----------------------------|----------------------------|
| December 2005 | 8.0808                     | 8.0702                    | 7.7548                      | 7.7516                     |

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|               |        |        |        |        |
|---------------|--------|--------|--------|--------|
| January 2006  | 8.0702 | 8.0596 | 7.7571 | 7.7506 |
| February 2006 | 8.0616 | 8.0415 | 7.7618 | 7.7564 |
| March 2006    | 8.0415 | 8.0167 | 7.7618 | 7.7564 |
| April 2006    | 8.0248 | 8.0040 | 7.7598 | 7.7529 |
| May 2006      | 8.0300 | 8.0005 | 7.7575 | 7.7510 |

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**B. Capitalization and Indebtedness**

Not applicable.

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

Not applicable.

**D. Risk Factors**

**Risks Relating to Our Business**

*Our cellular businesses face intense competition from China Mobile Communications Corporation, or China Mobile, China Telecom Corporation Limited, or China Telecom, and China Network Communications Group Corporation, or China Netcom. Such competition may intensify and result in slower subscriber growth, lower tariffs and higher customer acquisition costs for us, which would materially adversely affect our financial condition, results of operations and growth prospects.*

Our cellular businesses face intense competition from China Mobile. China Mobile is the largest cellular operator in China and has competitive advantages over us in areas such as customer base, financial resources and brand recognition. We are experiencing intense competition from China Mobile in our cellular service areas, and such competition may continue and intensify. In particular, continued price competition between China Mobile and us in many service areas has accelerated the decline of the average revenue per user per month, or ARPU, of our cellular services, and adversely affected our profitability. Moreover, China Mobile has announced its intention to launch 3G cellular services in the future, which could further intensify the competition with our cellular businesses, particularly our CDMA services.

Our cellular services also compete with the local wireless telecommunications services of China Telecom and China Netcom in their respective service areas, known as Little Smart services, which are based on their fixed line networks and primarily utilize the personal handy-phone system, or PHS, technology. They are offered as extensions of fixed line services and, with such features as calling-party-pays arrangements, carry significantly lower tariffs than cellular services. The Little Smart services were previously offered primarily in small- to medium-sized cities, but have been introduced in most major cities nationwide since 2003. Currently these services have attracted over 90 million users in China and their subscriber base is continuing to grow. In addition, both China Telecom and China Netcom have announced their intention to develop 3G cellular services in the future, which would impose direct competition with our cellular business.

Increased competition from China Mobile, China Telecom and China Netcom could lead to slower subscriber growth, lower traffic volume of our services, continued price pressure and higher costs of customer acquisition, which may materially adversely affect our financial condition, results of operations and growth prospects.

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***Our CDMA services may not succeed in gaining a broader market acceptance in China.***

We are the only cellular operator offering CDMA services in China. Prior to the introduction of our CDMA services in 2002, digital cellular services in China were mostly based on the global system for mobile communications, or GSM, technology. The majority of cellular subscribers in China today continue to be GSM subscribers. CDMA cellular services compete with GSM services for cellular subscribers, who may be reluctant to switch to CDMA cellular services because of the need to obtain a new CDMA handset and a new phone number. CDMA services are also perceived to have limitations in international roaming due to the lack of CDMA networks in many countries. In addition, CDMA handsets are generally more expensive than GSM handsets. As of December 31, 2005, the total number of our CDMA subscribers has reached 32.72 million in our service areas. Nevertheless, in comparison with 393 million cellular subscribers in China as of December 31, 2005, CDMA services have yet to gain a broader market acceptance in China.

Whether our CDMA services can gain broader market acceptance will continue to be subject to a number of uncertainties, including, among others:

- whether we can effectively retain our existing subscribers and attract sufficient new CDMA cellular subscribers;
- whether we can effectively reduce the cost of CDMA handsets and marketing expenses and strengthen the management of the purchase and distribution processes of the CDMA handsets; and
- whether we can generate more revenues from value-added services by capitalizing the technological advantages of CDMA 1X wireless data services.

Any of these uncertainties may adversely affect the growth and profitability of our CDMA cellular services and consequently our financial condition and results of operation.

***Our CDMA and GSM businesses may compete with each other, which may adversely affect the growth and profitability of these businesses.***

Although we are committed to coordinating the development of our CDMA and GSM businesses, these two businesses may compete with each other for our financial, management, human and other resources as well as cellular subscribers. For example, since we have expanded our CDMA services into the mass market, our CDMA business may compete with our GSM business for mid- and low-end cellular subscribers. A portion of our CDMA subscribers were former subscribers of our GSM services. If the development of our CDMA and GSM services is not coordinated effectively or we cannot obtain adequate resources for both our GSM and CDMA cellular services, the growth and profitability of these businesses and our financial condition, results of operations and growth prospects may be adversely affected.

***Failure to continually expand and upgrade our networks and infrastructure or changes in telecommunications technology and technological standards could adversely affect our competitive position and hinder our growth.***

The growth of our businesses depends on whether we are able to continue to expand the coverage and capacity of our networks, to upgrade the technology and to improve the quality of our networks in a timely and effective manner. We also need to continue to improve the quality of our existing networks in order to enhance our telecommunications services.

In addition, the telecommunications industry in China and elsewhere in the world is subject to rapid and significant changes in technology and technological standards, including, among others, the technology migration to 3G and the development of voice-over-internet protocol technology, or VOIP. Such changes may render our networks and systems obsolete or inadequate. As a result of such changes, we may need to make significant changes and upgrades to our existing networks and infrastructure or construct new networks and infrastructure, which may require substantial capital expenditures and other resources.

Our ability to expand and upgrade our networks and infrastructure is subject to a number of uncertainties, including our ability to achieve the following on a timely basis and on acceptable terms:

- obtain adequate financing;
- obtain relevant government licenses, permits and approvals;
- manage the technology migration in an effective manner;
- obtain adequate network equipment and software;
- retain experienced management and technical personnel;
- obtain sufficient spectrum frequencies, network numbers and other telecommunication resources controlled by the PRC government;
- gain access to the sites for network construction or upgrade; and
- enter into interconnection and other arrangements with other operators.

If we are not able to timely and effectively overcome these uncertainties and other difficulties we may encounter in expanding and upgrading our networks and infrastructure, our competitive position, financial condition, results of operations and growth prospects may be adversely affected.

***We may be unable to fund our capital expenditure and debt service requirements, which may adversely affect our financial condition and growth prospects.***

We continue to have a significant level of capital expenditure and debt service requirements. We plan to spend approximately RMB22.00 billion for capital expenditure in 2006, an increase of RMB4.39 billion or 24.9% from 2005. As of December 31, 2005, the sum of our long-term and short-term interest bearing debt exceeded the amount of our cash, cash equivalents and short-term bank deposits by RMB28.3 billion. See

Liquidity and Capital Resources under Item 5. In the future we may be unable to obtain the necessary financing on a timely basis and on acceptable terms, and our failure to do so may adversely affect our financial condition, competitive position and growth prospects. Our ability to obtain acceptable financing at any time may depend on a number of factors, including, among others:

- our financial condition and results of operations,
- our creditworthiness and relationship with lenders,
- the condition of the economy and the telecommunications industry in China,
- conditions in relevant financial markets in China and elsewhere in the world, and
- our ability to obtain any required government approvals for our financings.



***The CDMA handset promotional packages have increased our costs and expenses and may adversely affect our profitability.***

In order to accelerate the development of the CDMA business and subscriber growth during the product introduction period, we began to offer certain CDMA handset promotional packages in the second half of 2002. Under those arrangements, CDMA handsets were provided to the subscribers for their use at no additional cost to them during the specified contract periods as long as such subscribers agreed to incur a minimum amount of service fees during the contract period. The maximum contract period is two years. The cost of the handsets provided to subscribers under these contractual arrangements, treated as deferred customer acquisition costs, were deferred, to the extent recoverable, and amortized over the contractual period during which we expect to receive the minimum contract revenue. Therefore, these promotional packages tend to increase our costs and expenses.

While we substantially reduced the use of such CDMA handset promotional packages since 2003, the carrying amount of the deferred customer acquisition costs remain significant. For the year ended December 31, 2005, amortization of such deferred customer acquisition costs amounted to approximately RMB5,948 million and the carrying amount of such costs amounted to RMB2,944 million as of December 31, 2005. As a result, while the use of these CDMA promotional packages has accelerated the growth of our CDMA business, they may adversely affect the profitability of our CDMA business and our financial condition and results of operations.

In order to control the costs of our CDMA promotional packages, we have adopted the policy to centralize the purchases of CDMA handsets since 2005. In July 2005, we established a subsidiary, Unicom Huasheng Telecommunications Technology Company Limited, or Unicom Huasheng, which primarily manages the purchase and distribution of CDMA handsets for us. Such centralized purchase policy has resulted in us maintaining a certain level of inventory of CDMA handsets that is subject to the risk of inventory obsolescence. As of December 31, 2005, we maintained an inventory of CDMA handsets of RMB930 million.

***Our long distance, data and Internet businesses remain relatively small*** comparing to China Telecom and China Netcom, and competition from China Telecom, China Netcom and other telecommunication service providers may adversely affect our profitability and growth in these businesses.

The fixed line operators of China Telecom and China Netcom currently hold a dominant market position in the public switched long distance telephony, or PSTN, and data services markets in China in their respective service areas. They are also the dominant providers of Internet protocol telephony, or IP telephony, and Internet access services in China. China Telecom and China Netcom have competitive advantages over us in customer base, financial resources, fixed network coverage and last-mile access. Our IP telephony services compete with other service providers including China Satellite Communication, or China SatCom and China Railway Communications Co. Ltd., or China Railcom. In 2005, intense competition has continued to contribute to the decreases in average realized tariff rates for long distance services and in our revenue from long distance business. The growth of our long distance, data and Internet businesses has been further hindered by our lack of licenses to operate local telephony networks. Competition from China Telecom, China Netcom and other service providers may continue to adversely affect the profitability and growth of our long distance, data and Internet businesses and consequently our overall financial condition and results of operations.

***Our churn rates and doubtful debt ratio*** may increase.

The monthly average churn rate of our GSM cellular services slightly increased from 2.30% in 2004 to 2.41% in 2005. Such increase was primarily due to the following factors:

- intense competition from the GSM services of China Mobile and the Little Smart services of China Telecom and China Netcom;
- the increase in the proportion of cost-sensitive subscribers among new subscribers as a result of continuing expansion of our GSM cellular services in the mass market; and
- an increase in the proportion of subscribers to our pre-paid GSM services which are characterized by a higher churn rate than post-paid services.

Although the monthly average churn rate of our CDMA cellular services stood at 1.49% in 2005, the same level in 2004, there is no assurance that it will not increase in the future. Increased churn rates of our GSM and CDMA services may adversely affect our market share and increase our costs of additional customer acquisitions and bad debt, which would adversely affect our financial condition, results of operations and growth prospects.

China has yet to develop an effective credit control system, and with intense competition in the cellular telecommunication market, our doubtful debt ratio for cellular services, calculated as the amount of provision for doubtful debt divided by revenue from our cellular services, may increase in the future. While our doubtful debt ratio decreased from 2.8% as of December 31, 2004 to 1.8% as of December 31, 2005 due to our improved management of payment delinquency in 2005, there is no assurance that it will not increase in the future. If such ratio increases in the future, our financial condition and results of operations could be adversely affected.

***Obstacles in interconnection with networks of other telecommunication operators could jeopardize our operations.***

The effective provision of our cellular, long distance telephony and other services requires the interconnection between our networks and the networks of China Telecom, China Netcom, China Mobile and other telecommunication operators. Any obstacles in existing interconnection arrangements or any significant change of their terms, as a result of natural events, accidents, or for regulatory, technological, competitive or other reasons, could lead to temporary service disruptions and increased costs that can seriously jeopardize our operations and adversely affect our profitability and growth. Difficulties in the execution of new interconnection arrangements on a timely basis and on acceptable terms, including the inability to promptly establish additional interconnection links or increase interconnection bandwidths as required, could also adversely affect our financial condition, results of operation and growth prospects.

***Our controlling shareholder, Unicom Group, can exert influence on us and cause us to make decisions that may not always be in the best interests of our other shareholders.***

Unicom Group indirectly controls an aggregate of 52.36% of our issued share capital as of May 31, 2006. As our controlling shareholder, it is able to influence our major business decisions through its control of our board of directors. All of our executive directors and executive officers also serve as directors or executive officers of Unicom Group. In addition, our operations depend on a number of services provided by Unicom Group. For example, Unicom Group leases to us, on an exclusive basis, capacity on the CDMA network located in our cellular service areas, provides us with access to international gateways, supplies us with SIM cards and calling cards and provides equipment procurement services and customer services to us. Unicom Group and we also provide a number of services to each other, including interconnection and roaming services, sales agency and collection services and provision of premises. See A. History and Development of the Company— Our Relationship with Unicom Group under Item 4 of this annual report. The interests of Unicom Group and our interests in these transactions may differ and Unicom Group may cause us to make decisions that conflict with the interests of our other shareholders.

***The internal reorganization of Unicom Group for the A Share offering has created a two-step voting mechanism that will require the approval of the minority shareholders of both our Company and the A Share Company for significant connected transactions between us and Unicom Group.***

In October 2002, Unicom Group completed an internal reorganization of its shareholding in our company and the initial public offering in China, of its newly established subsidiary, China United Telecommunications Corporation Limited, or A Share Company. As part of this restructuring, a portion of Unicom Group's indirect shareholding in our company was transferred to the A Share Company, whose business is limited to indirectly holding the equity interest of our company without any other direct business operations. A voting mechanism was established to allow public shareholders of the A Share Company to indirectly participate in our shareholders' meetings and a two-step voting mechanism was established for the approval of connected transactions. See A. History and Development of the Company— Further Restructuring of Unicom Group and Initial Public Offering of the A Share Company in 2002 under Item 4 below. As a result, significant connected transactions between us or our subsidiaries and Unicom Group or its subsidiaries will require the separate approval of the independent minority shareholders both of our company and of the A Share Company. Connected transactions approved by our independent minority shareholders nevertheless cannot proceed if they are not approved by the independent minority shareholders of the A Share Company. This adds another necessary step of approval process for those transactions.

***Investor confidence and the market prices of our shares and ADSs may be materially and adversely impacted if we are or our independent registered public accounting firm is unable to conclude that our internal control over financial reporting is effective as of December 31, 2006 as required by Section 404 of the Sarbanes-Oxley Act of 2002.***

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We are a public company in the United States that is subject to, among other things, the Sarbanes-Oxley Act of 2002. Section 404 of the Sarbanes-Oxley Act of 2002 requires that we include a report of management on our internal control over financial reporting in our Annual Report on Form 20-F that contains an assessment by management of the effectiveness of our internal control over financial reporting. In addition, our independent registered public accounting firm must audit and report on management's assessment of the effectiveness of our internal control over financial reporting. These requirements will first apply to our Annual Report on Form 20-F for the fiscal year ending December 31, 2006. Our management may conclude that our internal control over financial reporting is not effective. Even if our management concludes that our internal control over financial reporting is effective, our independent registered public accounting firm may disagree. If our independent registered public accounting firm is not satisfied with our internal control over financial reporting or the level at which our controls are documented, designed, operated, reviewed or evaluated, or if the independent registered public accounting firm interprets the relevant requirements, rules or regulations differently from us, then it may decline to attest to our management's assessment or may issue an adverse opinion. Any of these possible outcomes could result in an adverse reaction in the financial marketplace due to a loss of investor confidence in the reliability of our consolidated financial statements, which could materially and adversely affect the market prices of our shares and ADSs.

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***We may incur increased costs as a result of being a public company.***

As a public company listed on the New York Stock Exchange and The Stock Exchange of Hong Kong Limited, we incur a higher level of accounting, legal and other expenses than many private companies. In addition, the Sarbanes-Oxley Act of 2002, as well as new rules subsequently implemented by the Securities and Exchange Commission, or the SEC, and the New York Stock Exchange, have required changes in corporate governance and internal control practices of public companies. We expect these new rules and regulations to increase our legal and financial compliance costs and to make certain corporate activities more time-consuming and costly. We are currently evaluating and monitoring developments with respect to these new rules, and we cannot predict the amount of additional costs we may incur or the timing of such costs.

**Risks Relating to the Telecommunications Industry in China**

***Regulatory or policy changes relating to the PRC telecommunications industry or future industry restructuring may materially adversely affect our financial condition, results of operations and growth prospects.***

The PRC government continues to regulate many aspects of the telecommunications industry in China. Potential changes in regulations and policies and their implementation could lead to changes in the overall industry environment. These changes may include, among others, new regulatory decisions or measures relating to issuance of 3G licenses or selection of 3G technology standards, calling-party-pays arrangements or other tariff adjustments, fulfillment of telecommunications service providers universal service obligations and the associated expenses, usage of numbers or frequency resources and the associated fees, or standards and mechanisms of interconnection settlement, and could substantially affect our financial condition, results of operations and growth prospects. For example, if the PRC government decides to grant 3G licenses to one or more of our competitors but not to us, or deregulates or reduces state tariff rates applicable to some of our services, our results of operations and financial condition may be materially and adversely affected.

In addition, the PRC government has in the past restructured the telecommunications industry through a number of initiatives that were rolled out in stages and may initiate further industry restructuring in the future. Potential restructuring of the PRC telecommunications industry, if any, may affect the overall business environment and the operations of telecommunications operators in China, including us. We cannot predict the timing for, and any implications and effect of, any future restructuring of the PRC telecommunications industry, or give any assurance that we will not be materially adversely affected by any such industry restructuring.

***Issuance of additional telecommunication service licenses, including 3G licenses, may further intensify competition in the PRC telecommunications industry and materially adversely affect our financial condition, results of operations and growth prospects.***

Since mid 1990s, the PRC government has taken various measures, including licensing more providers of telecommunications services, to encourage competition in the telecommunications industry. Currently, the Chinese telecommunications market has six basic telecommunications service providers—China Telecom, China Mobile, China Netcom, China Satcom, China Railcom, and our Company—and thousands of value-added service providers. In addition, the government may grant additional telecommunications service licenses in the future, including additional licenses to provide 3G cellular services.



The PRC government has not publicly announced its decisions on the timing of the grant of the 3G licenses, the number of 3G licenses to be granted, or the selection of preferred 3G technology standards. The issuance of 3G licenses to cellular service providers may significantly change the overall competition environment of the wireless telecommunications industry and further intensify the competition among cellular service providers. While we have participated in the 3G trial tests sponsored by the MII and have been preparing for developing 3G business by upgrading our CDMA and/or GSM network and services, we cannot assure you that the PRC government will grant us the requisite approvals and license(s) in a timely or favorable manner, or at all. We cannot predict the 3G technology standards that may be selected by the PRC government for the 3G license(s) that may be granted to us. Even if we are granted one or more 3G licenses, we cannot assure you that we will successfully manage the technology migration to 3G and 3G operations and effectively compete with other cellular services providers.

After its accession to the World Trade Organization, or WTO, in December 2001, China promulgated the Administrative Regulations on Telecommunications Companies with Foreign Investment, implementing its commitments to the WTO. Those commitments include the gradual reduction of foreign ownership restrictions in the telecommunications industry and the step-by-step opening of the telecommunications market in China to foreign operators. By the end of 2006, there will be no geographic restriction for foreign telecommunication service provider to provide mobile voice and data telecommunication services in China. See *Regulatory and Related Matters* *Entry into the Industry* under Item 4. When the PRC government grants licenses to additional telecommunications service providers in the future, licensees may include foreign-invested operators. Such foreign-invested operators entering into China's telecommunications market may have competitive advantages over us in areas such as financial resources, network management and technical expertise.

Increased competition in China's telecommunications services industry could impede the growth of our businesses, further increase competition for skilled and experienced employees, result in or exacerbate price competition and increase our customer acquisition costs and other costs and expenses, and thereby adversely affect our results of operations, financial condition and growth prospects.

*The telecommunications industry in China may not sustain its pace of rapid growth, which may adversely affect the growth and profitability of our business.*

The telecommunications industry in China has experienced rapid growth in the last several years, especially in the cellular communications sector. The total number of cellular subscribers in China increased from 43.3 million at the end of 1999 to 393 million by December 31, 2005. Cellular penetration increased from 3.5% to 30.3% nationwide during the same period. The growth in cellular subscribers has been slowing down as cellular penetration continues to increase in our cellular service areas. In addition, ARPU for the cellular communications market in China continues to decline. For example, ARPU of our GSM subscribers declined from RMB49.4 in 2004 to RMB48.5 in 2005. Any slow-down in the growth in China's telecommunications industry may adversely affect the growth and profitability of our business.

*The PRC government may require us, along with other telecommunication service 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 PRC government authorities, and the MII has the authority to delineate the scope of universal service obligations. The MII, 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.

While specific universal services obligations are not yet clear, we believe that such services may include mandatory provision of basic telecommunications services in less economically developed areas in China and mandatory contribution to a universal service fund. In addition, as part of the transitional measures prior to the formalization of a universal service obligation framework, the MII has required major telecommunication service providers in China, including Unicom Group, to participate in a project to provide telephone services in thousands of remote villages in China. In participating in such project, Unicom Group, with our assistance, undertook the universal service obligation to extend telecommunication service coverage to a total of more than 4,600 administrative-level villages in 2004 and 2005 primarily through its CDMA and satellite transmission networks. In 2006, Unicom Group is required to extend telecommunication service coverage to more than 1,500 additional villages in remote areas. See B. Business Overview Regulatory and Related Matters Universal Services under Item 4.

We cannot predict whether the PRC government will specifically require us to undertake universal service obligations in the future. To the extent we are required to do so, it is currently uncertain whether we will be adequately compensated by the government or by the universal service fund. We cannot assure you that we will be able to realize an adequate return on investments for expanding networks to, and providing telecommunications services in, those less economically developed areas due to potentially higher capital expenditure requirements, lower usage by customers and lack of flexibility in setting our tariffs. We also cannot predict whether we will be required to make contribution to the universal service fund. Any of these events may adversely affect our financial condition and results of operations.

*Actual or perceived health risks associated with the use of mobile devices could impair our ability to retain and attract customers, reduce cellular service usage or result in litigation.*

Concerns have been expressed in some countries that the electromagnetic signals emitted by wireless telephone handsets and base stations may pose health risks at exposure levels below existing guideline levels, and interfere with the operation of electronic equipment. In addition, cellular operators have been subject to lawsuits alleging various health consequences as a result of cellular handset usage or proximity to base stations or seeking protective or remedial measures. While we are not aware that such health risks have been substantiated, there can be no assurance that the actual, or perceived, risks associated with the transmission of electromagnetic signals will not impair our ability to retain customers and attract new customers, reduce cellular service usage or result in litigation.

#### **Risks Relating to Doing Business in China**

*Our operations may be adversely affected by changes in China's economic, political and social conditions.*

Substantially all of our business operations are conducted in China and substantially all of our revenues are derived from our operations in China. Accordingly, our business, financial condition, results of operations and prospects are affected to a significant degree by economic, political and social conditions in China. The PRC economy differs from the economies of most developed countries in many respects, including with respect to the amount of government involvement, level of development, growth rate, control of foreign exchange and allocation of resources. While the PRC economy has experienced significant growth in the past three decades, growth has been uneven across different regions and among various economic sectors. The PRC government has implemented various measures to encourage economic development and guide the allocation of resources. Some of these measures benefit the overall PRC economy, but may also have a negative effect on us. For example, our financial condition and results of operations may be adversely affected by government control over capital investments or changes in tax regulations that are applicable to us. Since early 2004, the PRC government has implemented certain measures to control the pace of economic growth. These measures may cause a decrease in the level of economic activity in China, including a decline in individual spending activities, which in turn could adversely affect our financial condition and results of operations.

*If the PRC government revises the current regulations that allow a foreign investment enterprise to pay foreign exchange in current account transactions, our operating subsidiary's ability to satisfy their foreign exchange obligations and to pay dividends to us in foreign currencies may be restricted.*

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The ability of our wholly-owned operating subsidiary, China Unicom Corporation Limited, or CUCL, to satisfy their foreign exchange obligations and to pay dividends to us depends on existing and future foreign exchange regulations in China. The Renminbi is currently convertible by foreign-invested enterprises in China to settle transactions under the current account, which include trade and service related foreign exchange transactions and payments of dividends and interest on foreign loans. Renminbi currently cannot be freely converted without regulatory approval for transactions under the capital account, which include outbound foreign investment and principal payments on foreign loans. CUCL, which holds substantially all of our assets and through which we conduct substantially all of our business, is a foreign-invested enterprise in China. This status allows them to purchase foreign exchange at designated foreign exchange banks for settlement of current account transactions without the approval of the State Administration for Foreign Exchange. However, there is no assurance that the relevant PRC government authorities will not in the future impose any limitation on the ability of foreign-invested enterprises to purchase foreign exchange to satisfy their foreign exchange obligations or to pay dividends. In that event, CUCL's ability to satisfy its foreign exchange obligations and to pay dividends to us in foreign currencies may be restricted.

*Fluctuations in the value of the Renminbi could adversely affect the prices of our shares and ADSs as well as our profitability.*

Substantially all of our revenues and costs and expenses are denominated in Renminbi, while a portion of our borrowings, equipment purchases and other capital expenditures are denominated in foreign currencies. On July 21, 2005, the PRC government changed its decade-old policy of pegging the value of Renminbi to that of U.S. dollar. Under the new policy, the Renminbi is permitted to fluctuate within a narrow and managed band against a basket of certain foreign currencies determined by the People's Bank of China. The Renminbi may appreciate or depreciate significantly in value against the U.S. dollar or other foreign currencies in the long term, depending on the fluctuation of the basket of currencies against which it is currently valued, or it may be permitted to enter into a full float, which may also result in a significant appreciation or depreciation of the Renminbi against the U.S. dollar or other foreign currencies. Fluctuations of the Renminbi could adversely affect the value in foreign currency terms of cash flow generated from our operations or any dividends payable on our shares and ADSs, and therefore the price of our shares and ADSs. Any future Renminbi devaluations could also increase our equipment acquisition costs and costs and expenses or lead to significant fluctuations in the exposure of our foreign-currency-denominated liabilities, thereby adversely affecting our profitability.

*Uncertainties in the PRC legal system could limit the legal protections available to us and to foreign investors.*

Our wholly-owned operating subsidiary, CUCL, is organized under the laws of PRC and is generally subject to laws and regulations applicable to foreign-invested enterprises in China. The Chinese legal system is a civil law system based on written statutes. Unlike common law systems, it is a system in which decided legal cases may be cited for reference but have limited precedential value. Since 1979, the PRC 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 volume of published cases and their non-binding nature, interpretation and/or enforcement of these laws and regulations involves uncertainties. Therefore, the PRC legal system may not afford the same legal protection available to investors in the United States or elsewhere.

*Any future outbreak of health epidemics or other adverse public health developments may severely disrupt our business and operations.*

Adverse public health epidemics or pandemics could disrupt businesses and the national economy of China and other countries and regions where we do business. From December 2002 to June 2003, China and other countries experienced an outbreak of a new and highly contagious form of atypical pneumonia now known as severe acute respiratory syndrome, or SARS. Recently, some Asian countries, including China, have encountered incidents of the H5N1 strain of bird flu, or avian flu. We are unable to predict the effect, if any, that avian flu may have on our business. In particular, any future outbreak of SARS, avian flu or similar adverse public health developments may, among other things, significantly disrupt our ability to adequately staff our business, and may adversely affect our operations. Furthermore, an outbreak may severely restrict the level of economic activity in affected areas, which may in turn materially and adversely affect our business and prospects. As a result, we cannot assure you that any future outbreak of SARS, avian flu or similar adverse public health developments would not have a material adverse effect on our financial condition and results of operations.

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

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

###### **Industry Restructuring**

Since 1993, the PRC government has implemented a number of measures to restructure and introduce competition in the telecommunications industry. Prior to June 1994, China Telecom was the sole provider of telecommunications services in China. In June 1994, Unicom Group was established in accordance with the State Council's approval to introduce competition in the telecommunications industry. Since then, the PRC government has approved Jitong Network Communications Company Limited, or Jitong, and China Netcom Corporation Ltd., or CNCL, to provide IP telephony, Internet and data services. It has also approved China Railcom to provide most telecommunications services other than cellular services.

In 1999, the State Council approved a plan to restructure the former China Telecom along four business lines: fixed line, cellular, paging and satellite communications. As a result of the restructuring, China Telecom retained the fixed line, data and Internet businesses, while China Mobile assumed the cellular business previously operated by China Telecom. In 2002, the PRC government further separated China Telecom into two companies, with the southern company retaining the name of China Telecom and assets and businesses in 21 provinces in southern and western China and the northern company retaining assets and businesses in 10 provinces in northern China and merging with CNCL and Jitong to form China Netcom. As a result of the PRC government's efforts to introduce competition in the telecommunications industry, there is currently more than one service provider in most of the sectors within the telecommunications industry. See B. Business Overview-Competition below.

###### **History of Unicom Group**

As part of its efforts to introduce orderly competition to the telecommunications sector in China, the State Council approved the proposal to establish Unicom Group in December 1993 and authorized it to build and operate cellular networks and local and long distance networks. Since its establishment in June 1994, Unicom Group first developed a nationwide cellular network using GSM technology and a nationwide long distance telephony network. In May 1997, the State Council granted approval to Unicom Group to provide data services. The MII licensed Unicom Group to begin to provide Internet services in July 1999 and IP telephony services on a trial basis in 12 cities in April 1999 and on a nationwide basis in March 2000.

Unicom Group offers local telephony services in the municipalities of Chengdu, Chongqing and Tianjin. It also offers satellite transmission services through its subsidiary, China United Telecommunications Satellite Communication Co. Ltd., or Unisat.

#### **The Restructuring of Unicom Group and Our Initial Public Offering in 2000**

We are a company limited by shares incorporated under the Companies Ordinance of Hong Kong on February 8, 2000. Our registered office and principle executive offices are located at 75th Floor, The Center, 99 Queen's Road Central, Hong Kong (telephone number: 852-2126-2018).

Under reorganization agreement, dated April 21, 2000, between Unicom Group and CUCL, Unicom Group transferred to CUCL certain of its assets, rights and liabilities in preparation for our initial public offering, or IPO. Under an equity transfer agreement, dated April 21, 2000, among us, Unicom Group, China Unicom (Hong Kong) Group Limited and China Unicom (BVI) Limited, or Unicom BVI, Unicom Group transferred to us its 100% equity interest in CUCL, which became our wholly-owned operating subsidiary in China. In return, we issued 9,725 million shares to Unicom BVI, then an indirectly controlled subsidiary of Unicom Group.

In June 2000, we successfully completed our IPO, raising approximately US\$5.65 billion. Upon completion of our IPO, our shares became listed and traded on The Stock Exchange of Hong Kong Limited and ADSs representing our shares became listed and traded on the New York Stock Exchange.

#### **Further Restructuring of Unicom Group and Initial Public Offering of the A Share Company in 2002**

After our IPO, Unicom BVI, which was a wholly-owned subsidiary of China Unicom (Hong Kong) Group Limited, or Unicom HK, a wholly-owned subsidiary of Unicom Group, directly held 77.47% of our outstanding shares. In October 2002, Unicom Group completed an internal restructuring of its shareholding in our company. Unicom HK transferred the total issued capital of Unicom BVI held by it to Unicom Group and Unicom BVI became a direct wholly-owned subsidiary of Unicom Group. Unicom Group then transferred 51% of its equity interest in Unicom BVI to the A Share Company, a newly established holding company and subsidiary of Unicom Group. The A Share Company's business is limited to indirectly holding the equity interest of our company without any other direct business operations.

Following the restructuring, the A Share Company successfully completed its IPO in the PRC and the listing of its ordinary shares on the Shanghai Stock Exchange, or A Shares. After the IPO of the A Share Company, the A Share Company transferred all of its net offering proceeds to Unicom Group in return for an additional 22.84% equity interest in Unicom BVI.

In accordance with the articles of association of the A Share Company and Unicom BVI, before Unicom BVI votes on a certain proposal at our shareholders' meeting, the A Share Company must first convene its shareholders' meeting to consider the same proposal and has the right to direct Unicom BVI to vote the shares in our company indirectly held by the A Share Company through Unicom BVI. Unicom Group can similarly direct the voting in respect of its direct equity interest in Unicom BVI. This mechanism for voting is designed to allow public shareholders of the A Share Company to indirectly participate in our shareholders' meeting.

The voting mechanism described above, however, will not apply to the approval process for any connected transactions between us or our subsidiaries and Unicom Group or its subsidiaries, on which Unicom BVI will not be permitted to vote under the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited, or the HKSE Listing Rules. Instead, our significant connected transactions would require the separate approvals of the public shareholders both of our company and of the A Share Company. According to the two-step voting arrangements we and the A Share Company have established, each connected transaction between us or our subsidiaries and Unicom Group or its subsidiaries will consist of an initial agreement and a further agreement. The initial agreement would be entered into by Unicom Group or its subsidiaries (excluding the A Share Company and its subsidiaries) on the one hand and the A Share Company or Unicom BVI on the other hand. This agreement would contain the following terms:

- the closing of the initial agreement would be subject to the (i) successful transfer of all rights and obligations of the A Share Company or Unicom BVI under the initial agreement to us or our subsidiaries, and (ii) the approval of the further agreement by our independent shareholders, and
- Unicom Group or its subsidiaries (excluding the A Share Company and its subsidiaries) would agree and acknowledge that all rights and obligations under the initial agreement can be transferred to us or our subsidiaries without any further consent requirements.

The initial agreement will constitute a connected transaction of the A Share Company and, if certain thresholds are met, will require the approval of the public or independent shareholders of the A Share Company under the rules of the Shanghai Stock Exchange. The further agreement would be entered into by the A Share Company or Unicom BVI on the one hand and us or our subsidiaries on the other hand, and would provide for the transfer of all rights and obligations of the A Share Company or Unicom BVI on the one hand under the initial agreement to us or our subsidiaries on the other hand. The further agreement will constitute a connected transaction of our company and, if certain thresholds are met, will require the approval of our public or independent shareholders under the HKSE Listing Rules. We expect, to the extent the nature of a particular connected transaction allows, the two-step voting arrangements to apply as described above. However, there may be circumstances where the nature of the connected transaction requires the application of the two-step voting arrangements to be adjusted. This may arise where we or our subsidiaries are the providers, rather than recipients, of certain services. In this event, the two-step voting arrangements will need to be adjusted so that the process as described above is effectively reversed, such that the initial agreement is entered into by us or our subsidiaries rather than Unicom Group or its subsidiaries (excluding the A Share Company and its subsidiaries) with the A Share Company or Unicom BVI. Unicom Group or its subsidiaries (excluding the A Share Company and its subsidiaries), rather than us or our subsidiaries, will be party to the further agreement. The arrangements (including the conditions) will apply correspondingly. This two-step structure will be applied in all future connected transactions between us and Unicom Group and will effectively require the separate approvals of the public or independent shareholders both of our company and of the A Share Company for such connected transactions.

#### **Acquisitions of Unicom New Century and Unicom New World and the Sale of Guoxin Paging**

On December 31, 2002, in accordance with the two-step approach outlined above, we successfully completed the acquisition from Unicom Group of Unicom New Century, which holds cellular telecommunications businesses (including GSM assets and businesses and CDMA businesses) in the following nine provinces, autonomous regions and municipalities in China: Jilin, Heilongjiang, Jiangxi, Henan, Shaanxi and Sichuan provinces, Guangxi Zhuang Autonomous Region, Xinjiang Uygur Autonomous Region and Chongqing municipality. The total purchase price was HK\$4,523,181,304 (approximately RMB4.8 billion), payable in cash.



On December 31, 2003, we successfully completed the acquisition from Unicom Group of Unicom New World, which holds cellular telecommunications businesses (including GSM assets and businesses and CDMA businesses) in the following nine provinces and autonomous regions in China: Shanxi, Hunan, Hainan, Yunnan, Gansu and Qinghai provinces and Inner Mongolia, Ningxia Hui and Xizang Zang autonomous regions. The total purchase price was HK\$3,014,886,000 (approximately RMB3.2 billion), payable in cash. On the same date, we also completed the sale of the entire equity interests of Guoxin Paging to Unicom Group for a total sale price of HK\$2,590,917,656 (approximately RMB2.75 billion), and such proceeds were applied to our general working capital.

As a result of the acquisitions of Unicom New Century and Unicom New World, CUCL extended its cellular businesses to 30 provinces, autonomous regions and municipalities in China.

**Mergers of Unicom New Century and Unicom New World into CUCL**

On July 30, 2004, Unicom New Century was merged into CUCL and legally dissolved upon the completion of such merger. On September 1, 2005, Unicom New World was merged into CUCL and legally dissolved upon the completion of such merger.

**Acquisition of China Unicom International Limited**

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In September 2004, we acquired from Unicom Group of Unicom International, a limited liability company established in Hong Kong engaging in voice wholesale business, telephone cards business, line leasing services, managed bandwidth services and mobile virtual network services. Unicom International's wholly-owned US subsidiary, China Unicom USA Corporation, or Unicom USA, carries wholesale business of voice traffic between the United States and mainland China. The total purchase price was HK\$37,465,996 (approximately RMB39.74 million), payable in cash.

### **Establishment of Unicom Macau and the Launch of CDMA Services in Macau**

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On October 15, 2004, we set up China Unicom (Macau) Company Limited, or Unicom Macau, in the Macau Special Administrative Region of the PRC, or Macau. In March 2005, the Macau government granted Unicom Macau a CDMA license, which allows Unicom Macau to provide roaming services and, subject to the Macau government's further approval, provide CDMA cellular services to local CDMA users in Macau after the first year of its operation. In October 2005, Unicom Macau completed the construction of CDMA network in Macau and launched the CDMA roaming service to CDMA users in Macau.

### **Incorporation of Unicom Huasheng**

On July 1, 2005, CUCL and Unicom Xingye Science and Technology Trade Co., or Unicom Xingye, a subsidiary of Unicom Group, incorporated Unicom Huasheng, a 95%-owned subsidiary of CUCL. Unicom Huasheng is principally engaged in sales of handsets and telecommunication equipment and provision of technical services for us.

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### **Share Segregation Reform of the A Share Company**

On May 11, 2006, the relevant shareholders of the A Share Company approved a proposal by all the holders of the non-tradable shares of the A Share Company, including Unicom Group, to convert their non-tradable shares into shares that are listed and tradable on the Shanghai Stock Exchange. This proposal was made pursuant to and in compliance with PRC regulations in respect of share segregation reform of companies listed in the PRC. In connection with the conversion of all non-tradable shares into tradable shares, holders of the non-tradable shares of the A Share Company will transfer to each holder of tradable shares 2.8 non-tradable shares for every ten tradable shares held by such holder as of May 17, 2006. The tradable shares converted from non-tradable shares are subject to certain lock-up restrictions as required by the relevant PRC regulations. As a result of the implementation of this proposal, Unicom Group's ownership interest in the A Share Company decreased from 69.32% to 60.74%.

As of May 31, 2006, Unicom Group held a 60.74% equity interest in the A Share Company. The A Share Company in turn held 82.10% of the total equity interest in Unicom BVI, with the remaining 17.90% held directly by Unicom Group. Unicom BVI continues to hold 77.27% of our outstanding shares and Unicom Group remains our ultimate controlling shareholder. See also the chart below for the current shareholding structure of our company.

Set forth below is our shareholding structure and subsidiaries as of May 31, 2006.

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**Our Relationship with Unicom Group**

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Unicom Group continues to own and manage the international gateways that provide international connections to our long distance network. Unicom Group also continues to operate the following telecommunications networks:

- its cellular networks in Guizhou province,
- its local telephony networks in Chengdu, Chongqing and Tianjin municipalities,
- the satellite transmission networks operated through Unisat, and
- the paging networks operated through Unicom Paging and Guoxin Paging.

Unicom Group holds the licenses required for our telecommunications businesses and we derive our rights to operate our businesses from our status as a subsidiary of Unicom Group. Under the respective reorganization agreements entered into by CUCL, Unicom New Century and Unicom New World with Unicom Group referred to above, Unicom Group undertook to hold and maintain all licenses received from the MII in connection with our businesses solely for our benefit during the term of the licenses and at no cost to us. In addition, Unicom Group undertook to take all actions necessary to obtain and maintain for our benefit such governmental licenses or approvals as we shall require to continue to operate our businesses. Unicom Group also agreed not to engage in any business which competes with our businesses except for the then-existing competing businesses of Unicom Group and to grant us a right of first refusal in relation to any government authorization, license or permit, or other business opportunity to develop any new telecommunications technology, product or service. Finally, Unicom Group also gave us an undertaking not to seek an overseas listing for any of its businesses or the businesses of its subsidiaries in which we are engaged or may engage in the future, except through us.

In connection with the restructuring of Unicom Group and the acquisitions of Unicom New Century, Unicom New World and Unicom International, we entered into a number of agreements with Unicom Group pursuant to the two-step process described in Further Restructuring of Unicom Group and the Initial Public Offering of A Shares above. These include arrangements for interconnection and roaming services between the telecommunications networks owned by us and Unicom Group and for the provision or sharing of telecommunications and ancillary services and facilities between us and Unicom Group. Unicom Group also retains its interests in its other subsidiaries that provide ancillary services to us, including the procurement of telecommunications equipment and the supply of SIM cards and calling cards. In March 2005, we entered into several new agreements with Unicom Group to replace the existing arrangements. See B. Related Party Transactions under Item 7 for a detailed description of our agreements with Unicom Group.

Unicom Group has constructed nationwide cellular networks based on CDMA IX technology. We entered into lease agreements with Unicom Group to lease a portion of the network capacity and began to offer CDMA cellular services on an exclusive basis in our cellular service areas in early 2002. In March 2005, we entered into a new CDMA lease agreement with Unicom Group to replace the then existing CDMA lease agreements. Unicom Group only operates its CDMA networks in Guizhou province, which is outside of our cellular service areas. We also have an option to acquire the CDMA networks from Unicom Group. See B. Related Party Transactions- Leasing of CDMA Network Capacity under Item 7.

## Capital Expenditures and Divestitures

See Liquidity and Capital Resources- Capital Expenditures under Item 5 for information concerning our principal capital expenditures for the previous three years and those planned for 2006. We have not undertaken any significant divestitures.

### **B. Business Overview**

#### **General**

We are an integrated telecommunications operator in China, offering a comprehensive range of telecommunications services, including cellular, international and domestic long distance, data and Internet services based on our advanced, uniform nationwide network system. We offered cellular communications services based on both GSM and CDMA technologies in 30 provinces, autonomous regions and municipalities in China (i.e., all provinces, autonomous regions and municipalities in China except for Guizhou province). We and China Mobile are currently the two cellular service providers in our cellular service areas.

We had a total of 95.07 million GSM cellular subscribers in our cellular service areas as of December 31, 2005, representing a 12.7% increase from 84.27 million subscribers as of December 31, 2004. Our GSM cellular business accounted for 59.9% of our total revenue in the year ended December 31, 2005. We had approximately 32.72 million CDMA cellular subscribers in our cellular service areas as of December 31, 2005, representing a 17.6% increase from 27.81 million subscribers as of December 31, 2004. Our CDMA Cellular business contributed 34.8% of our total revenue in the year ended December 31, 2005. At the end of 2005, our market share in our cellular service areas was 34.5%, slightly decreasing from 35.6% at the end of 2004.

We provide international and domestic long distance, data and Internet services nationwide in China. These businesses currently represent a relatively small portion of our overall business. Our long distance, data and Internet businesses collectively accounted for 5.3% of our total revenue in 2005, compared to 7.0% in 2004. Outgoing public switched and IP telephony long distance calls totaled 10.48 billion and 14.73 billion minutes, respectively, in 2005, compared to 10.10 billion and 13.95 billion minutes, respectively, in 2004. Our incoming international long distance calls (including incoming calls from Hong Kong, Macau and Taiwan) totaled 2.59 billion minutes in 2005, down from 2.75 billion minutes in 2004. As of December 31, 2005, the bandwidth of our data network, international interconnection bandwidth and domestic interconnection bandwidth had reached 54,828MGbps, 4,272MGbps and 17,755MGbps, respectively. We had 8.53 million Internet subscribers at the end of 2005.

Our fiber optic transmission network continued to expand in 2005. As of December 31, 2005, the total cable length of our transmission network reached 796,000 km, including 122,000 km for our backbone transmission network, representing an increase of 11.8% and 1.7%, respectively, from the end of 2004.

#### **Recent Developments**

As of March 31, 2006, the total number of our GSM subscribers in our cellular service areas has increased to 97.91 million, including 49.71 million post-paid subscribers and 48.20 million pre-paid subscribers. As of March 31, 2006, we also had a total of 33.64 million subscribers to our CDMA services. Average minutes of usage, or MOU, per subscriber per month for GSM services in our combined service areas were 218.9 minutes for the three months ended March 31, 2006. Average MOU per subscriber per month for CDMA services in combined service areas were 264.1 minutes for the three months ended March 31, 2006. ARPU for GSM services in our combined service areas was RMB49.4 for the three months ended March 31, 2006. ARPU for CDMA services in our combined service areas was RMB68.5 for the three months ended March 31, 2006. For the three months ended March 31, 2006, outgoing public switched and IP telephony long distance calls totaled 2.40 billion minutes and 3.28 billion minutes, respectively. As of March 31, 2006, we had 8.04 million Internet subscribers.

On June 20, 2006, we entered into a strategic alliance framework agreement with SK Telecom Co., Ltd., or SKT, a mobile telecommunications service provider in Korea. Pursuant to this agreement, we and SKT agreed to cooperate on the further development of CDMA cellular communication services in China. We have appointed SKT as our sole and exclusive partner in relation to our CDMA cellular communication business operations for a maximum period of 18 months in PRC in the areas of CDMA handsets, value-added services and related business platform, marketing, information technology infrastructure and network technologies. Detailed terms of our business cooperation with SKT will be negotiated in the future and set forth in definitive legal agreements to be entered into by us and SKT. We and SKT will establish a joint designated team to implement the business cooperation initiatives. In addition, pursuant to this agreement, if SKT and/or any of its affiliates, individually or collectively, hold more than 5% of our issued share capital, SKT will be entitled to nominate a representative to our board of directors. SKT has undertaken to cause such director to resign if it and/or its affiliates, individually or collectively, hold no more than 5% of our issued share capital for a period of three months.

On June 20, 2006, we and SKT also entered into a subscription agreement whereby SKT agreed to subscribe for US\$1,000,000,000 zero coupon convertible bonds due 2009 to be issued by us on July 5, 2006, or such other date agreed by us and SKT which may not be later than July 12, 2006. Subject to certain adjustments pursuant to the terms of the bonds, such bonds can be converted into our ordinary shares one year after the issuance at an initial conversion price of HK\$8.63 (US\$1.11) per share, representing a 28.8% premium over the closing price of our ordinary shares on the Hong Kong Stock Exchange on June 20, 2006. Assuming a full conversion of the bonds at this initial conversion price, the bonds would be convertible into 899,745,075 ordinary shares, representing approximately 7.15% of our issued and outstanding share capital as of June 20, 2006 and approximately 6.67% of our enlarged issued and outstanding share capital as of the date of the conversion. Unless previously redeemed, converted or purchased and cancelled pursuant to the terms of the bonds, we will redeem all the outstanding bonds at 104.26% of their principal amount on July 5, 2009. In addition, the holders of such bonds, with prior written notice to us, may require us to redeem, on July 5, 2008, all or a portion of their bonds at 102.82% of the principal amount of the bonds to be redeemed. The proceeds from this issuance of convertible bonds are currently intended to be used for general operational purposes.

### **Cellular Services**

Our cellular business is our largest business, with our GSM and CDMA businesses together having contributed 94.7% of our total revenue in 2005.

We offer both GSM and CDMA cellular services in our service areas. We began to offer GSM cellular services in 1995 and currently a majority of our existing cellular users subscribe to our GSM cellular services. We began to offer CDMA cellular services in 2002. In 2003, we introduced wireless data services that utilize CDMA 1X technology. We also offer GSM international roaming services in conjunction with 248 operators in 118 countries and regions and CDMA international roaming services in conjunction with 18 operators in 15 countries and regions.

In 2004, we began to offer GSM and CDMA dual mode cellular handset service under the brand name Worldwind. In April 2005, we launched Worldwind dual-mode card service based on the handset business. As of December 31, 2005, we had 254,000 Worldwind dual-mode service subscribers.

In October 2005, we successfully launched the CDMA network in Macau to provide roaming services for all CDMA users in Macau. This was the first time a PRC telecommunications operator launched a cellular network outside mainland China.

We also offer a broad range of value-added services to our cellular subscribers, including short message services, or SMS, personalized call-back ring tone services, CDMA 1X wireless data services and GSM wireless data services, under the integrated business brand of uni, which represents various wireless value-added services we offer for our cellular subscribers. In 2005, the proportion of our total cellular service revenue generated from value-added services increased to 15.0% from 10.1% in 2004.

### **GSM Cellular Services**

We centrally plan and oversee our GSM cellular business, which are operated by provincial branches of our operating subsidiary, CUCL. We centrally manage the key aspects of network construction such as network planning and design and selection of major equipment. We also centrally devise the overall business strategies to be carried out by the provincial operating branches.

Our GSM cellular networks reach all cities, county centers, major towns, major highways and railways in our cellular service areas. We continue to selectively deploy GSM systems that operate in the 1800 MHz frequency band in high-density population and high call volume centers to supplement our GSM networks operating in the 900 MHz frequency band. In 2005, we focused on optimizing the operational efficiency and stability of our GSM networks, and will continue to manage our GSM networks to support the development of our various cellular services. In addition, we upgraded our GSM networks in 2005 to launch general packer radio service, or GPRS, services in Beijing, Shanghai, Guangzhou,



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Shenzhen, Zhuhai, Dongguan and Suzhou. In 2006, we plan to upgrade our GSM networks in additional 50 to 100 major cities to offer GPRS services in those cities.

### *Post-paid Services and Pre-paid Services*

We offer two main categories of GSM cellular services: post-paid and pre-paid services that target different consumer segments. Generally, we promote our pre-paid services to migrant population and temporary residents as well as mass market subscribers and target our post-paid services at consumers who have relatively high usage of telecommunication services.

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We grant tailored credit lines to post-paid service subscribers based on their usage and creditworthiness. To subscribe for our post-paid services, a customer generally needs to produce proof of local residency or a guarantee from a local resident and sign a service contract. A post-paid subscriber pays per-minute usage and roaming charges. We maintain and update detailed customer data for post-paid subscribers and implement other credit control measures to ensure they generally have good creditworthiness.

To subscribe for our pre-paid services, a customer simply purchases a SIM card with a pre-paid amount of service charges. The customer can add to the pre-paid balance by purchasing rechargeable cards. We do not grant credit lines to our pre-paid service subscribers.

Our pre-paid services target mass market cellular subscribers. These services are generally supported by intelligent networks built by us. The intelligent network platform enables us to offer nationwide roaming services and monitor in real time the account balance of pre-paid subscribers.

*Subscribers and Usage*

The following table sets forth selected historical information about our GSM cellular operations and our subscriber base for the periods indicated.

|  | CUCL and Unicom New Century, as of or for the year ended December 31, | CUCL(5) and Unicom New World, as of or for the year ended December 31 | CUCL(6) as of or for the year ended December 31 | CUCL(6), as of or for the three months ended March 31, |
|--|---|---|---|--|
|  | 2003  | 2004  | 2005  | 2006   |
| Number of subscribers (in thousands)                 | 63,923  | 84,267  | 95,071  | 97,908   |
| Post-paid  | 32,458  | 42,844  | 48,166  | 49,711   |
| Pre-paid   | 31,465  | 41,423  | 46,905  | 48,197   |
| Estimated market share in our service areas(1)       | 27.4  | % 26.8  | % 25.6  | % 25.2   |
| Average churn rate(2)                                | 29.1  | % 27.6  | % 28.9  | % 7.2  |
| Average minutes of usage per subscriber per month(3) | 173.70  | 188.9   | 202.2   | 218.9  |
| Average revenue per subscriber per month (in RMB)(4) | 56.74   | 49.4  | 48.5  | 49.4   |
| SMS Volume (in billions)                             | 25.034  | 32.39   | 39.51   | 12.91  |

(1) Market share in a given area is determined by dividing the number of our GSM subscribers in the area by the total number of cellular subscribers in the area. *Source:* Ministry of Information Industry.

(2) Average churn rate is the rate of subscriber disconnections from our GSM cellular network, which we have determined by dividing the sum of voluntary and involuntary deactivations during the period by the average of the number of our GSM subscribers during the period.

(3) Average minutes of usage per subscriber per month is calculated by dividing the total minutes of usage during the period by the average of the number of our GSM subscribers during the period, and dividing the result by the number of months in the relevant period.

(4) Average revenue per subscriber per month, or ARPU, is calculated by dividing the sum of GSM cellular services revenue during the relevant period by the average of the number of our GSM subscribers during the period, and dividing the result by the number of months in the period.

(5) Includes Unicom New Century, which merged into CUCL on July 30, 2004.

(6) Includes Unicom New Century and Unicom New World, which merged into CUCL on July 30, 2004 and September 1, 2005, respectively.

*Subscriber Increase:* Our subscriber base continued to grow rapidly. As of December 31, 2005, the total number of GSM subscribers in our cellular service areas increased to 95.07 million, including 48.17 million post-paid subscribers and 46.91 million pre-paid subscribers. Our share of the cellular market in terms of total cellular subscribers in our GSM cellular service areas was 34.5% as of December 31, 2005. We attracted 27.4% of the net cellular subscriber additions in those service areas during 2005. We believe that this growth was attributable to a number of factors, including, among others, (i) continued growth of the Chinese cellular telecommunications market, driven by economic growth and reduction in the cost of cellular handsets and services, (ii) our sales and marketing efforts, (iii) relatively competitive pricing of our services and (iv) our customer service.

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*Pre-paid Subscribers:* The rate of increase in our pre-paid subscribers has generally been at the same level as the rate of increase in our post-paid subscribers in recent years. As of December 31, 2005, we had 46.91 million pre-paid subscribers in our cellular service areas, representing 49.3% of our total subscriber base, an increase of 0.1% from 49.2% as at the end of 2004.

*MOU and ARPU:* MOU and ARPU of our GSM services were 217.44 billion minutes and RMB48.5, respectively, in 2005. The average MOU per subscriber per month was 202.2 minutes in 2005, an increase of 13.3 minutes from 188.9 minutes in 2004. The increase in MOU was attributable to increased competition with our competitor, which resulted in the provision of more call minutes in the package service plans offered to subscribers. The decreasing effective tariffs as a result of such competition also encouraged higher usage among subscribers. ARPU of our GSM services continued to decline from RMB49.4 in 2004 to RMB48.5 in 2005, which decline was attributable to intensified market competition and regional promotional activities that led to a decline in effective tariffs, as well as the fact that an increasing proportion of our new subscribers are mid- to low-end users. Our pre-paid subscribers in general have lower MOUs and ARPUs compared to our post-paid subscribers.

*Churn Rate:* For the year ended December 31, 2005, the churn rate for GSM services in our cellular service areas increased from 27.6% in 2004 to 28.9% primarily as a result of intensified competition and the fact that a larger portion of our GSM subscribers are low- to mid-end subscribers. Our calculation of churn rate reflects those subscribers who switch to services of other operators and those whose services we terminate as a result of account inactivity or payment delinquency.

As competition continues to intensify, our churn rate from subscribers voluntarily discontinuing our services may further increase in the future. The churn rate for our pre-paid services is generally higher than that for our post-paid services because of the price sensitivity and the migrant and temporary nature of many pre-paid subscribers.

*Payment Delinquency:* Payment delinquency stabilized in 2005. As of December 31, 2005, the doubtful debt ratio for GSM cellular services in our cellular service areas, calculated as the amount of provision for doubtful debt divided by revenue from GSM cellular services, is 1.7%, significantly lower than the 2.8% at the end of 2004. The decrease was primarily due to our improved management of payment delinquencies. In some of our cellular service areas we require our post-paid subscribers to deposit service charges and maintain a certain level of account balances with us or with commercial banks that collect service fees for us. We classify the creditworthiness of our subscribers into various levels and have adopted other credit control measures. We also closely manage payment delinquencies through confirmation of customer address and other registration information, expansion of collection channels, advance notification of inadequate deposits, close monitoring of call patterns and account balances and prompt termination of services.

#### *Tariffs*

Generally the categories of tariffs we charge our cellular subscribers include, among others, basic monthly fees, usage charges for both local incoming and outgoing calls, domestic and international roaming charges, long-distance call charges and charges for value-added services.

The cellular tariffs are set forth by the MII and tariff adjustments are subject to regulation by various government authorities, including the MII, the National Development and Reform Commission and price regulatory authorities. The following table summarizes the present State guidance tariff rates for post-paid and pre-paid cellular services:

|                                      | Post-paid Services | Pre-paid Services |
|--------------------------------------|--------------------|-------------------|
|                                      | RMB                | RMB               |
| Basic monthly fee                    | 50                 | 0                 |
| Basic usage charge (per minute)      | 0.4                | 0.6               |
| Domestic roaming charge (per minute) | 0.6                | 0.8               |

Source: MII.

Intense competition in our cellular service areas has resulted in tariff discounts and service promotions offered by both us and our main competitor from time to time, which may lower effective tariffs. These discounts and promotions have taken many forms, including promotional tariff rates, free call minutes, off-peak discounts or discounts for high-usage subscribers and package service plans with fixed monthly fees. While various features of our package service plans are coordinated on a nationwide basis, the tariff structure of the various plans are determined by us based on the local competitive environment. See **D. Risk Factors** Risks Relating to the Overall Telecommunications Industry in China Regulatory or policy changes relating to the PRC telecommunications industry or future industry restructuring may materially adversely affect our financial condition, results of operations and growth prospects under Item 3.

We have introduced a number of package service plans in our cellular service areas. Under these plans, subscribers pay a fixed monthly fee for a specified number of call minutes. The plans vary in the level of the fixed monthly fee, the number of specified call minutes and the tariff rates for call minutes in excess of the specified call minutes. The terms of these plans also vary depending on the local markets and generally offer some price discounts to similar plans of our main competitor. We have also introduced in selected cities promotional plans for certain qualified subscribers, which allow such subscribers to receive incoming calls without incurring per-minute usage charges in exchange for a fixed monthly fee.

In 1997, the PRC government granted us preferential treatment by allowing us to reduce our tariffs by up to 10% below the State guidance tariff rates. In the past, this preferential treatment has helped us capture a significant number of cellular subscribers by allowing us to market our cellular services at discounted rates. As we and our main competitor introduced various package service plans and other promotional programs, the tariff structure has become more complex. While we continue to maintain tariff levels that are generally lower than those of our main competitor, the more complex tariff structure has, to some extent, made our price advantages less obvious to subscribers compared to previous tariff schemes that were largely based on simple per-minute charges. In 2005, as we continued to offer package service plans in our service areas, we have significantly reduced the variety of such plans and stopped offering service plans that were not profitable. We also further centralized the package service planning to provincial-level branches and higher.

#### **CDMA Cellular Services**

Our controlling shareholder, Unicom Group, currently has the exclusive license to offer CDMA cellular services in China. It has constructed a CDMA network with comprehensive nationwide coverage through its wholly-owned subsidiary, Unicom New Horizon Mobile Telecommunications Company Limited, or Unicom New Horizon. We have leased CDMA network capacity from Unicom Group and offer CDMA cellular services and CDMA 1X wireless data services.

#### *Unicom Group's Construction of CDMA Networks*

In May 2001, Unicom Group began to build CDMA networks nationwide. The networks are expected to be expanded in phases. The number and size of each phase will depend upon actual and forecast CDMA subscriber growth and anticipated capacity requirements. In the first phase of the construction, which was completed by the end of 2001, the networks achieved a nationwide coverage of approximately 330 cities in China, with a total capacity of 15.81 million subscribers.

In 2003, Unicom Group completed the second phase of the CDMA network construction, which included the upgrade of the network to CDMA 1X technology. The second phase of the construction also added capacity for 20.69 million additional subscribers.

By the end of 2005, Unicom Group has substantially completed the third phase of the CDMA network construction, which increased the total CDMA network capacity to 82.2 million subscribers, with 80.8 million of capacity within our service areas. Such level of capacity improved our CDMA nationwide network coverage and telecommunications quality, including both outdoor and indoor coverage, as well as the data-processing capacity of our CDMA 1X services.

#### *Our Lease of CDMA Networks from Unicom Group*

Our wholly-owned operating subsidiary, CUCL, entered into a lease agreement with Unicom Group and its subsidiary Unicom New Horizon, dated November 22, 2001, which sets forth the principal terms of the network capacity leasing arrangement between us and Unicom Group. Unicom New Century and Unicom New World have also entered into lease agreements, dated November 20, 2002 and November 20, 2003, respectively, with Unicom Group and Unicom New Horizon on similar terms and conditions. We entered into a new, consolidated lease agreement, or the New CDMA Lease, with Unicom Group and Unicom New Horizon on March 24, 2005 to replace the three then existing lease agreements, or the Old CDMA Leases. See B. Related Party Transactions Leasing of CDMA Network Capacity under Item 7.

The New CDMA Lease has an initial term of two years commencing from January 1, 2005, during which (i) the lease fee for the first year will be 29% of the audited service revenue generated by our CDMA cellular business and (ii) the lease fee for the second year will be 30% of the audited service revenue generated by our CDMA business. The term of the New CDMA Lease may be renewed at our option, with the length of the renewed term to be agreed upon. We are currently considering our renewal option upon the expiration of the initial two-year term of the New CDMA Lease.

We lease all constructed CDMA network capacity from Unicom Group and operate these CDMA networks in our cellular service areas on an exclusive basis and receive all revenue generated from the operation. We may terminate the lease arrangements upon giving at least six months prior notice to Unicom Group.

In addition to leasing network capacity, we also have the option, exercisable at any time during the lease period and for an additional year thereafter, to purchase the CDMA network in our cellular service areas. The acquisition price will be negotiated between Unicom New Horizon and us. It will be based on the appraisal value of the CDMA network determined by an independent appraiser in accordance with applicable PRC laws and regulations and take into account the then prevailing market conditions and other factors. However, the purchase price will not exceed an amount which would, taking into account all lease fee payments made by us to Unicom New Horizon and lease fee discounts as a result of any delay of delivery, enable Unicom New Horizon to recover its total network construction costs, together with an internal rate of return of 8%. The exercise of the purchase option will be subject to the relevant laws, regulations and the HKSE Listing Rules, including approvals of our minority shareholders for connected transactions. See B. Related Party Transactions Leasing of CDMA Network Capacity under Item 7 for a more detailed description of the New CDMA Lease.

#### *Services*

The CDMA services we offer in our cellular service areas include basic voice and value-added services such as call forwarding and voicemail, caller identity display, SMS services and CDMA 1X wireless data services. The features of our pre-paid and post-paid CDMA services are similar to pre-paid and post-paid GSM services. See B. Business Overview Cellular Services GSM Cellular Services Post-paid Services and Pre-paid Services under this Item 4.

In August 2004 and April 2005, we launched CDMA and GSM dual-mode cellular handset and card services, respectively, under the brand name Worldwind. As of December 31, 2005, we had approximately 254,000 subscribers of the Worldwind dual-mode cellular services.

Worldwind dual-mode services, which are available to our subscribers who use either a dual-mode handset or a dual-mode user card, have the following features:

- Users can switch between our GSM and CDMA networks in China, thereby offering wireless coverage in areas of the country covered by any one of these networks;
- When roaming in areas outside of China, users can use the cellular services of local operators, whether they are GSM or CDMA, who signed roaming agreements with us; and
- Our GSM users who sign up for Worldwind can continue to use the basic GSM services, while enjoying the additional benefits of the CDMA 1X services.

*Subscriber Base*

The following table sets forth selected historical information about our CDMA cellular operations and our subscriber base for the periods indicated.

|  | CUCL and Unicom New Century, as of or for the year ended December 31, | CUCL(5) and Unicom New World, as of or for the year ended December 31, | CUCL(6) as of or for the year ended December 31 | CUCL(6) as of or for the three months ended March 31, |   |
|--|---|--|---|---|---|
|  | 2003  | 2004   | 2005  | 2006  |   |
| Number of subscribers (in thousands)                 | 16,910  | 27,814   | 32,722  | 33,636  |   |
| Post-paid  | 16,046  | 25,824   | 30,010  | 30,888  |   |
| Pre-paid   | 864   | 1,991  | 2,713   | 2,748   |   |
| Estimated market share in our service areas(1)       | 7.2   | % 8.8  | % 8.8   | % 8.7   | % |
| Average churn rate(2)                                | 11.5  | % 17.9   | % 17.9  | % 4.6   | % |
| Average minutes of usage per subscriber per month(3) | 337.5   | 292.3  | 276.9   | 264.1   |   |
| Average revenue per subscriber per month (in RMB)(4) | 128.4   | 85.3   | 75.1  | 68.5  |   |
| SMS Volume (in billions)                             | 6.231   | 11.83  | 15.02   | 4.15  |   |

(1) Market share in a given area is determined by dividing the number of our CDMA subscribers in the area by the total number of cellular subscribers in the area. *Source:* Ministry of Information Industry.

(2) Average churn rate is the rate of subscriber disconnections from our CDMA cellular network, which we have determined by dividing the sum of voluntary and involuntary deactivations during the period by the average of the number of our CDMA subscribers during the period.

(3) Average minutes of usage per subscriber per month is calculated by dividing the total minutes of usage during the period by the average of the number of our CDMA subscribers during the period, and dividing the result by the number of months in the relevant period.

- (4) Average revenue per subscriber per month, or ARPU, is calculated by dividing the sum of CDMA cellular services revenue during the relevant period by the average of the number of our CDMA subscribers during the period, and dividing the result by the number of months in the period.
- (5) Includes Unicom New Century, which merged into CUCL on July 30, 2004.
- (6) Includes Unicom New Century and Unicom New World, which merged into CUCL on July 30, 2004 and September 1, 2005, respectively.

As of December 31, 2005, our total CDMA subscriber base in our cellular service areas reached 32.72 million, representing an increase of 17.7% from 27.81 million subscribers at December 31, 2004. Among the total CDMA subscribers, post-paid subscribers increased by 16.2% from 25.82 million as of December 31, 2004 to 30.01 million as of December 31, 2005, while pre-paid subscribers increased by 36.2% from 1.99 million as of December 31, 2004 to 2.71 million as of December 31, 2005. Pre-paid subscribers represented 8.3% of the total number of CDMA subscribers in 2005. We believe the growth in our CDMA subscriber base was primarily attributable to:

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- increased brand awareness and our promotions and marketing efforts, including our adoption of new handset subsidizing policy that ties the handset subsidy to subscribers committed service fees,
- the availability of more affordable quality CDMA handsets as a result of our centralized purchasing policy,
- improved network coverage and quality, and
- the advantages of the CDMA technology, including the lower radio transmitting power of CDMA handsets as compared to GSM handsets, better voice quality and enhanced security.

*MOU, ARPU and Churn Rate*

In 2005, total MOU for our CDMA services was 101.75 billion minutes, an increase of 22.6% from 82.96 billion minutes in 2004, and ARPU for our CDMA services was RMB75.1, a decrease from RMB85.3 in 2004. Average MOU per subscriber per month for our CDMA services was 276.9 minutes, 36.9% higher than the average MOU of 202.2 minutes for GSM services, while our CDMA ARPU was 54.8% higher than the ARPU of RMB48.5 for our GSM subscribers. The reasons for the increase in MOU and the decrease in ARPU for our CDMA services in 2005 are similar to the reasons for similar trends in GSM services. See **B. Business Overview Cellular Services GSM Cellular Services MOU and ARPU** under this Item 4.

The churn rate for our CDMA services is calculated in the same way as the churn rate for our GSM services and was 17.8% in 2005, same as that in 2004, but is significantly lower than the 28.9% churn rate for our GSM services.

*Payment Delinquency*

As of December 31, 2005, the doubtful debt ratio for CDMA cellular services in our cellular service areas, calculated as the amount of provision for doubtful debt divided by revenue from CDMA cellular services, is 1.7%, significantly lower than 2.6% in 2004. We have taken various measures to control payment delinquency for our CDMA services, which measures are similar to the ones taken to control payment delinquency for our GSM services. See **B. Business Overview Cellular Services GSM Cellular Services Payment Delinquency** under this Item 4.

*Tariffs and Promotion*

The tariff rates for our CDMA services are generally the State guidance rates for cellular services without the 10% discount we are permitted to adopt for GSM services. However, we have adopted other promotional programs. Generally we charge our CDMA subscribers the following categories of tariffs: basic monthly fees, usage charges for both local incoming and outgoing calls, domestic and international roaming charges, long-distance call charges and charges for value-added services.

To accelerate the growth in our CDMA subscriber base, we have been offering certain CDMA handset promotional packages since the second half of 2002, providing discounts towards our customers' CDMA handset purchase prices on the basis of their committed minimum amount of monthly service fees.

Due to the high cost of the handset promotional packages and the improved coverage of CDMA network, as well as the increasing CDMA 1X functions, we have reduced the use of such packages recently, and concentrated instead on alternative promotional programs to develop our CDMA services. We offer differentiated services with various combination of voice and value-added services to effectively target various market sectors. In addition, we focused on expanding the sales and marketing channels for our CDMA services by significantly increasing the number of sales agents. Moreover, we have established a subsidiary, Unicom Huasheng, in 2005 to centralize the purchases and distribution of CDMA handsets to control the costs of our CDMA promotional packages.

*See D. Risk Factors Risks Relating to Our Business Our CDMA services may not succeed in gaining a broader market acceptance in China.* under Item 3.

#### **Value-added Services**

By leveraging our integrated telecommunication operations and advanced network system, we offer a broad range of value-added cellular services under a uniform business brand of uni , including SMS, wireless internet services, personalized call-back ring tone services and other wireless information services. Our value-added services have achieved rapid growth in recent years.

The volume of our SMS continued to increase rapidly in 2005. A total number of 54.53 billion short messages were transmitted by our GSM and CDMA subscribers in 2005, an increase of 23.3% over 2004. Our SMS services mainly include the following services: SMS transmission and receipt through handsets, service provider-assisted SMS, business SMS platform, voice SMS and other information services. We continue to promote the use of SMS as a convenient and cost effective method of business and personal communication. The SMS platforms of our GSM and CDMA networks are interconnected with each other. Our SMS platforms are also interconnected with the SMS platforms of China Mobile s GSM network, China Telecom s Little Smart network, and China Netcom s Little Smart network.

In August 2001, Unicom Group and we launched our nationwide GSM wireless data services under the service brand of Uni-Info . The Uni-Info services are based on a nationwide wireless information services platform and offer a variety of services including games, downloads and other entertainment services, information and notification services, personal information management and transactions services. We and Unicom Group cooperate with a number of national and regional service providers that supply our subscribers with Uni-Info services.

In March 2003, we launched CDMA 1X wireless value-added services under the uniform business brand of uni , with individual services offered under various sub-brands, including Uni-Info , U-Info , U-Net , U-Mail , U-Magic , U-Map and Uni-Web . U-Info services allow users and browse the Internet on their CDMA handsets. U-Net provides high-speed wireless Internet access to laptop computers and mobile handheld devices equipped with a wireless Internet card. U-Mail services allow users to (i) send and receive e-mails, either from other e-mail accounts or from the Internet and (ii) download and read attachments to the e-mail sent to the user s handset. U-Magic services allow users to download certain applications from the Internet to expand the functions of their handsets. These expanded functions include games, entertainment services, information services, image browsing and download services, music listening and browsing services and other applications. U-Map services provide location-based information to users handsets. Retail users can find locations and research information with respect to a particular location. This service also offers industrial applications, such as the logistics industry and sea rescue services. Uni-Web offers a series of services based on CDMA 1X technology, such as video pay-per-view, video download and video streams. In 2005, we focused our efforts in promoting CDMA 1X wireless value-added services in three areas: (1) increasing the market penetration, (2) easing the handset supply bottleneck by centralizing the purchase and distribution of CDMA handsets and (3) offering new services and service contents to activate more market demand. By the end of 2005, we had 15.05 million subscribers of CDMA 1X wireless value-added service, an increase of 72.7% over 2004.

In late 2003, we began to provide personalized call-back ring tone service under the brand name Cool Ringtong, which allows a cellular subscriber to select personalized ring tones that his or her callers will hear after dialing his or her cell phone number. This new value-added service has grown rapidly since its introduction. As of December 31, 2005, we had a total number of 21.95 million subscribers of our Cool Ringtong services, representing 17.2% of our total cellular subscriber base.

In 2004 and 2005, in order to develop our value-added services, we took the following measures:

- Through the improvement of the value-added services, more staff training, advertising and promotions, trial programs and our various other efforts, we strengthened marketing efforts for our value-added services under the uniform business brand of uni;
- We improved the content of our value-added services, through strengthening service support of and cooperation with content providers and service providers, in order to increase the appeal of these services;
- Through cooperation with partners in specific industries, we launched new applications such as Police Horizon, Maritime Horizon, Stock-in-Palm and Traffic Horizon; and
- We introduced value-added services specifically catering to the youth to support the launch of the U-Power customer brand that is designed for the youth market.

We have designed a fee structure under which we earn transmission fees from the use of our GSM and CDMA value-added services and charge a certain percentage of information service fees for the billing and collection services we provide to content providers and service providers.

#### **Long Distance, Data and Internet Services**

We offer international and domestic long distance services in China based on both the PSTN standard and the IP telephony standard. We leverage our ability to integrate our long distance services with a broad range of services to target different customer segments. We have also developed a nationwide video-conferencing network that reaches over hundreds of cities. We also offer data and Internet services throughout China. Our long distance, data and Internet services are supported by our advanced, unified nationwide network system.

The following table sets forth the total number of outgoing call minutes for our long distance services, leased bandwidth of our data services and number of dedicated access subscribers of Internet services for the periods indicated.

|   | As of or for the year ended December 31, |        |        |
|---|--|--------|--------|
|   | 2003                                     | 2004   | 2005   |
| Public switched telephony (in billions of minutes): |  |        |        |
| Domestic  | 8.31                                     | 9.94   | 10.33  |
| International                                       | 0.13                                     | 0.16   | 0.15   |
| Total   | 8.44                                     | 10.10  | 10.48  |
| IP telephony (in billion of minutes):               |  |        |        |
| Domestic  | 11.25                                    | 13.81  | 14.60  |
| International                                       | 0.14                                     | 0.14   | 0.13   |
| Total   | 11.39                                    | 13.95  | 14.73  |
| Data Services                                       |  |        |        |
| Bandwidth leased to customers (2Mbps)               | 7,194                                    | 9,007  | 8,706  |
| Internet Services                                   |  |        |        |
| Dedicated access subscribers                        | 47,750                                   | 61,569 | 38,000 |

#### Public Switched Telephony Services

We offer PSTN services to business and residential customers who register their telephone numbers with us. They can access our services by dialing a prefix of 193 . We also distribute pre-paid long distance calling cards that purchasers can use to access our services by dialing a prefix of 193300 . For some corporate and government customers, we also offer our public switched long distance services over dedicated lines, frequently as part of our integrated offerings of long distance and data services.

The following table sets forth selected information about our PSTN services for the periods indicated.

|  | As of or for the year ended on December 31, |       |       |   |
|--|---|-------|-------|---|
|  | 2003  | 2004  | 2005  |   |
| Number of cities reached                               | 329   | 332   | 333   |   |
| Minutes of outgoing long distance calls (in billion)   | 8.44  | 10.10 | 10.48 |   |
| Market share of outgoing long distance call minutes(1) | 14.33                                       | %     | 13.6  | % |
| Minutes of incoming international calls (in billion)   | 1.78  | 2.47  | 2.34  |   |

(1) *Source:* MII. In calculating market share, the total minutes of outgoing long distance calls include ours and those of the incumbent operators.

Starting from October 2005, the PRC government regulates the tariff rates for PSTN services by setting the maximum tariff rates. The following table sets forth our present tariff rates (including rates applicable to domestic and international long distance calls made by our cellular subscribers):

|  | Maximum Tariff Rates | Preferential Rates  |
|--|----------------------|---------------------|
|  | RMB per six seconds  | RMB per six seconds |
| Public switched Domestic Long Distance:      | 0.06                 | 0.03                |
| Public switched International Long Distance: |                      |                     |
| To Hong Kong, Taiwan and Macau               | 0.18                 | 0.15                |
| To all other international destinations      | 0.72                 | 0.38                |

Effective August 21, 2001, we adjusted the discount rates set forth in the table above as follows:



- RMB0.04 per six seconds every day from 8pm to 10pm;
- RMB0.03 per six seconds every day from 10pm to 7am of the following day; and
- RMB0.04 per six seconds on public holidays and weekends from 7am to 8pm.

Settlement of outgoing and incoming international calls with international operators is conducted through negotiated contracts with such individual international operators, which contracts must be approved by the MII.

*IP Telephony Services*

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We offer domestic and international long distance IP telephony services through interconnection of our IP network with the Internet and other telecommunications networks based on a manageable IP network configuration to enhance service quality. The following table sets forth selected information about our IP telephony services for the periods indicated.

|  | As of or for the year ended December 31, |       |       |
|--|--|-------|-------|
|  | 2003                                     | 2004  | 2005  |
| Number of cities reached                             | 337                                      | 341   | 341   |
| Minutes of outgoing IP telephony calls (in billion)  | 11.39                                    | 13.95 | 14.73 |
| Minutes of incoming international calls (in billion) | 0.13                                     | 0.28  | 0.25  |

Our IP telephony services include the following services:

- IP telephony services using the 17910 access code, which allows users to dial long distance phone numbers as follows: 17910 + IP card number + password + long distance number . There are three types of such services: (i) users can register for an IP card, pay the accumulated charges on the card on a monthly basis after receipt of a bill from us, (ii) users can purchase an IP telephony card with a pre-paid value, which can be re-filled after the user has used up the value on the card, or (iii) users can purchase an IP card with a one-time-only pre-paid value.
- IP telephony services using the 17911 access code, which allows users to dial long distance phone numbers as follows: 17911 + long distance number . There are two types of such services: (i) users can register for our services at any of our offices or our designated agents' offices free of charge, or (ii) users can purchase a pre-paid IP card from us, input the card number and password the first time the IP card is used, and thereafter dial international or domestic long distance calls only with the 17911 prefix.
- Dedicated IP telephony services users of these services only need to dial the long distance phone number to be connected.
- Direct IP telephony services Pursuant to authorization from the MII, we are providing fixed long distance direct-dialing IP telephony services nationwide. To promote our direct IP telephony services, we have set up many IP convenient stores nationwide. IP convenient stores are fixed-line long distance call centers in locations with a high concentration of the population who do not otherwise have access to fixed or wireless telephony services. These call centers provide long distance telephony services to customers on a pre-paid basis.

In February 2001, the PRC government ceased regulatory control of tariffs for IP telephony long distance calls and allowed operators to set their own rates. The following table sets forth our present tariff rates for our IP telephony services (including rates applicable to IP long distance calls made by our cellular subscribers).

|  | Our Tariff Rates (RMB) |
|--|------------------------|
| IP Telephony Domestic Long Distance      | 0.30 per minute        |
| IP Telephony International Long Distance |                        |
| To Hong Kong, Taiwan and Macau           | 1.5 per minute         |
| To U.S. and Canada                       | 2.6 per minute         |
| To other international destinations      | 3.6 per minute         |

Effective September 1, 2001, we adjusted our tariff rates for our IP telephony services for certain international destinations. The tariff rate for calls to 14 countries, including India, was adjusted to RMB4.60 per minute, and the tariff rate for calls to the U.S. and Canada was adjusted to RMB2.40 per minute.

**Data Services**

We presently provide data services in 328 cities in China. We target high volume users of integrated voice, data and video communications and offer them data services as part of our integrated offerings of long distance, data and Internet services. Our target customer groups are government offices, financial institutions, multinational or multi-regional corporations, large- and medium-sized enterprises in China, and Internet service providers and Internet content providers that provide telecommunications services. As of December 31, 2005, the total leased bandwidth of our ATM and FR data services was 8,706 x 2 Mbps.

Our data service offerings mainly consist of broadband, managed data services, including:

- Frame relay, or FR, services, which provide high speed and cost effective data communications services linking remote business sites using FR technology;
- Asynchronous transfer mode, or ATM, services, which employ ATM technology and are able to handle high bandwidth, integrated voice, video, data and Internet traffic; and
- Broadband video-conferencing and video-telephony services, which are provided under the brand name of Uni-Video. These services currently include video-conferencing, video-telephony, video conference room leasing and video public telephony services. These services are based on our existing unified data network platform. Two or more users can use our services by connecting to the Internet or our video network through video-conferencing terminals or computer terminals.

The following table sets forth selected information about our data services for the periods indicated.

|                               | As of December 31, |       |       |
|-------------------------------|--------------------|-------|-------|
|                               | 2003               | 2004  | 2005  |
| Number of cities reached      | 316                | 328   | 328   |
| Bandwidth leased to customers | 7,194              | 9,007 | 8,706 |

We provide data services through an advanced, unified nationwide network system, the backbone of which is our advanced nationwide fiber optic transmission network. This network is the second largest fiber optic transmission network in China. We have also built metropolitan area networks in many cities throughout China. These networks provide local transmission capacity for our different services. See Networks Transmission Network below.





We believe that our ability to offer integrated access to customers premises is important to the success of our data services. We continue to build integrated access networks linking major office buildings to our networks in major cities. See Networks Long Distance, Data and Internet Networks below.

Our charges for ATM and FR services include one-time, up-front charges for installation materials (currently RMB500 per port for ATM services and RMB300 per port for FR services) and testing (currently RMB500 per circuit or port for ATM services and RMB300 per circuit or port for FR services), a monthly port fee and a monthly circuit fee. Our tariff charges are generally offered at a 10% discount from the State guidance tariffs.

The following table sets forth our tariff rates for monthly port fees for FR data services of selected bandwidths.

| FR Services Port Fee (RMB per month) |          |
|--------------------------------------|----------|
| Bandwidth (bps)                      | Port Fee |
| 64k                                  | 260      |
| 128k                                 | 300      |
| 256k                                 | 400      |
| 384k                                 | 450      |
| 512k                                 | 500      |
| 768k                                 | 650      |
| 1M                                   | 750      |
| 2M                                   | 1,000    |

The following table sets forth our tariff rates for monthly permanent virtual circuit (PVC) fees for FR data services of selected bandwidths and selected distance categories.

| Bandwidth | FR Services PVC Fee (RMB per month) |                        |                        |                           |                                    |   |  |
|-----------|-------------------------------------|------------------------|------------------------|---------------------------|------------------------------------|---|--|
|           | Local (intra-district)              | Local (inter-district) | Domestic long distance | Hong Kong, Macau & Taiwan | International long distance (Asia) | International long distance (outside of Asia) |  |
| 8kbps     | 290                                 | 440                    | 990                    | 1,550                     | 8,800                              | 9,400   |  |
| 16kbps    | 390                                 | 540                    | 1,190                  | 1,800                     | 10,000                             | 10,500  |  |
| 32kbps    | 450                                 | 650                    | 1,300                  | 2,000                     | 11,500                             | 11,500  |  |
| 48kbps    | 500                                 | 750                    | 1,500                  | 2,300                     | 13,000                             | 13,500  |  |
| 64kbps    | 550                                 | 800                    | 1,700                  | 2,600                     | 14,500                             | 14,600  |  |
| 128kbps   | 700                                 | 1,000                  | 2,100                  | 3,400                     | 18,000                             | 18,400  |  |
| 256kbps   | 800                                 | 1,150                  | 2,200                  | 3,500                     | 19,000                             | 19,600  |  |
| 384kbps   | 850                                 | 1,350                  | 2,300                  | 3,800                     | 20,000                             | 20,500  |  |
| 516kbps   | 1,000                               | 1,450                  | 2,500                  | 4,100                     | 22,300                             | 23,100  |  |
| 768kbps   | 1,150                               | 1,600                  | 2,700                  | 4,600                     | 25,800                             | 26,550  |  |
| 1Mkbps    | 1,250                               | 2,000                  | 3,000                  | 5,200                     | 28,900                             | 30,050  |  |
| 2Mkbps    | 1,500                               | 2,200                  | 4,000                  | 7,000                     | 39,000                             | 39,000  |  |

The following table sets forth our tariff rates for monthly port fees for ATM services of selected bandwidth.

**ATM Services Port Fee (RMB per month)**

| <b>Bandwidth</b> | <b>Port Fee</b> |
|------------------|-----------------|
| 256K             | 400             |
| 512K             | 500             |
| 1M               | 750             |
| 2M               | 1,000           |
| 4M               | 2,000           |
| 6M               | 3,000           |
| 8M               | 4,000           |
| 10M              | 5,000           |
| 12M              | 6,000           |
| 34M              | 7,000           |
| 45M              | 8,000           |
| 100M             | 9,000           |
| 155M             | 10,000          |

The following table sets forth our tariff rates for monthly circuit fees for ATM data services of selected bandwidths and selected distance categories.

| <b>Bandwidth</b> | <b>ATM Services Circuit Fee (RMB per month)</b> |                               |                               |                                      |   |  |  |
|------------------|---|-------------------------------|-------------------------------|--------------------------------------|---|--|--|
|                  | <b>Local (intra-district)</b>                   | <b>Local (inter-district)</b> | <b>Domestic long distance</b> | <b>Hong Kong, Macau &amp; Taiwan</b> | <b>International long distance (Asia)</b> | <b>International long distance (outside of Asia)</b> |  |
| 256Kbps          | 800   | 1,150                         | 2,200                         | 3,500                                | 19,000                                    | 19,600   |  |
| 512Kbps          | 1,000   | 1,450                         | 2,500                         | 4,100                                | 22,300                                    | 23,100   |  |
| 1Mbps            | 1,250   | 2,000                         | 3,000                         | 5,200                                | 28,900                                    | 30,050   |  |
| 2Mbps            | 1,500   | 2,200                         | 4,000                         | 8,000                                | 39,000                                    | 39,000   |  |
| 4Mbps            | 2,000   | 3,000                         | 6,000                         | 12,900                               | 72,200                                    | 72,200   |  |
| 6Mbps            | 2,500   | 5,500                         | 9,000                         | 19,800                               | 105,400                                   | 105,400  |  |
| 8Mbps            | 3,500   | 8,500                         | 12,000                        | 26,700                               | 138,700                                   | 138,700  |  |
| 10Mbps           | 5,000   | 11,500                        | 15,500                        | 30,600                               | 157,800                                   | 157,800  |  |
| 15Mbps           | 7,000   | 15,000                        | 22,000                        | 40,000                               | 205,000                                   | 205,000  |  |
| 20Mbps           | 7,500   | 17,500                        | 29,000                        | 49,000                               | 252,300                                   | 252,300  |  |
| 25Mbps           | 8,000   | 21,000                        | 36,000                        | 59,000                               | 300,000                                   | 300,000  |  |
| 30Mbps           | 9,000   | 24,000                        | 42,000                        | 69,000                               | 348,500                                   | 348,500  |  |
| 40Mbps           | 10,000  | 29,000                        | 52,000                        | 88,500                               | 416,000                                   | 416,000  |  |
| 50Mbps           | 10,500  | 32,000                        | 60,000                        | 108,200                              | 486,600                                   | 486,600  |  |
| 60Mbps           | 11,000  | 33,000                        | 68,000                        | 122,600                              | 567,900                                   | 567,900  |  |
| 70Mbps           | 11,500  | 35,000                        | 76,000                        | 137,000                              | 649,100                                   | 649,100  |  |
| 80Mbps           | 12,000  | 36,000                        | 84,000                        | 151,300                              | 730,400                                   | 730,400  |  |
| 90Mbps           | 12,500  | 37,000                        | 92,000                        | 165,700                              | 811,600                                   | 811,600  |  |
| 100Mbps          | 13,000  | 37,500                        | 100,000                       | 180,100                              | 892,900                                   | 892,900  |  |
| 110Mbps          | 13,500  | 38,000                        | 107,500                       | 187,300                              | 933,500                                   | 933,500  |  |
| 130Mbps          | 13,800  | 38,500                        | 122,500                       | 201,600                              | 1,014,800                                 | 1,014,800  |  |
| 155Mbps          | 14,500  | 39,000                        | 130,000                       | 216,000                              | 1,096,000                                 | 1,096,000  |  |

Effective April 2003, we began charging our corporate customers fees for our Uni-Video services based on package service plans, including up-front charges for testing, a monthly fee and usage charges. Retail customers of our Uni-Video services purchase re-chargeable cards to pay for such services.



**Internet Services**

We offer the following Internet services:

- **Dedicated Internet Access.** We began to offer business customers high speed Internet access through dedicated lines in 2000. As of December 31, 2005, we had a total of 38,000 subscribers for dedicated Internet access. We package this service with voice and data services to provide integrated communications solutions to our business customers and cooperate with cable operators and real estate developers to offer broadband access to residential customers.
- **IDC Services.** We have built Internet data centers, or IDCs, in selected cities including Shanghai, Beijing, Guangzhou and certain provincial capitals, and provide server hosting, server rental, virtual servers and other IDC services to commercial customers and virtual IDC operators.
- **Dial-up Internet Access.** We began to offer dial-up Internet access services to customers in 2000. As of December 31, 2005, the total number of our dial-up subscribers decreased to 7.15 million from 13.56 million in 2004. This decrease is primarily the result of many dial-up subscribers switching to broadband Internet services that offer better quality and higher connection speed.
- **Ruyi Mailbox Services.** This service allows our cellular subscribers to use their cellular phone numbers as e-mail address. As of December 31, 2005, the number of Ruyi Mailbox subscribers was 8.47 million.
- **Others Internet Services.** Other Internet services we offer include a chain of Internet cafes (Unicom's Internet Plaza services), international Internet Protocol-Virtual Private Network (or IP-VPN), Virtual Private Data Network (or VPDN), Virtual Internet Service Provider (or VISP), Uninet international roaming and corporate e-mail services.

The following table sets forth selected historical information about our Internet service operations and our subscriber base for the periods indicated.

|  | As of December 31, |        |        |
|--|--------------------|--------|--------|
|  | 2003               | 2004   | 2005   |
| Number of cities reached by our dedicated Internet access services | 323                | 327    | 334    |
| Number of cities reached by our dial-up Internet access services   | 325                | 328    | 329    |
| Number of subscribers of dedicated Internet access services        | 47,750             | 61,569 | 38,000 |

Our tariff charges for dedicated Internet access include a network usage fee, an account set-up fee and a fixed telecommunications fee. Network usage fee is calculated based on monthly service plans. The account set-up fee is RMB100. The fixed telecommunications charge is based on the relevant tariff for the particular type and bandwidth of leased lines used to access the Internet. The following table summarizes the monthly network usage fees for selected bandwidths denoted as R .

| Bandwidth          | Network usage fees (RMB per month) |
|--------------------|------------------------------------|
| R≤64Kbps           | 2,700-3,600                        |
| 64Kbps<R≤128Kbps   | 3,600-4,900                        |
| 128Kbps<R≤256Kbps  | 4,800-6,600                        |
| 384Kbps <R<512Kbps | 8,500-12,000                       |
| 1024Kbps<R≤2Mbps   | 18,000-27,000                      |
| 8Mbps <R≤10Mbps    | 59,400-70,000                      |
| 20Mbps<R≤34Mbps    | 165,900-195,200                    |
| 34Mbps <R≤45Mbps   | 210,000-250,000                    |
| 45Mbps<R≤100Mbps   | 428,400-504,000                    |
| 100Mbps<R≤155Mbps  | 664,100-781,200                    |

Our provincial and local branches are permitted to make tariff decisions within the range set forth above. For customers who lease a high number of dedicated access lines, we provide discounts of up to 20% of the tariffs set forth in the table above.

We charge a monthly usage fee for our Ruyi Mailbox services, which is currently RMB6 per month. We do not charge for SMS notifications of e-mail receipt. Other e-mail functions performed through SMS are charged based on the SMS tariff rates for our uni-Info services.

We charge a network usage fee and a fixed telecommunications fee for our dial-up Internet services. The network code for our nationwide dial-up Internet services is 16500 . We distribute dial-up Internet access services through a variety of methods. A customer can pre-register for our dial-up services or purchase dial-up passwords with a pre-paid amount of on-line charges that can be used nationwide to access the Internet. We also have arrangements with a number of commercial banks that allow the banks' customers to access our dial-up services using their bank account numbers, with on-line charges being automatically debited from their bank accounts.

#### *Leased Line Services*

We began to lease transmission lines to large business customers and other telecommunications operators in April 2000. Our leased line services provide customers with dedicated digital links directly connecting customer sites. As of December 31, 2005, we had a total leased bandwidth of an equivalent of 55,741 x 2 Mbps circuits, representing an 8.0% increase from 51,598 x 2 Mbps circuits at the end of 2004.

Leased line tariffs are primarily based on the bandwidths of the lines leased and the distance of transmission. The following table sets forth State tariff rates for monthly fees of selected types and bandwidths of leased lines and selected distance categories:

|                         | State Tariff Rates (RMB per month) |                        |               |
|-------------------------|------------------------------------|------------------------|---------------|
|                         | Local (intra-district)             | Local (inter-district) | Long distance |
| Digital Line (2 Mbps)   | 2,000                              | 4,000                  | 6,000         |
| Digital Line (34 Mbps)  | 16,000                             | 31,000                 | 47,000        |
| Digital Line (155 Mbps) | 44,000                             | 88,000                 | 132,000       |

Source: MII.

Similar to PSTN services, operators other than incumbent operators, including us, can adopt tariffs that are different from the above State tariff rates upon approval by the MII as long as they do not offer services at tariff rates below cost. We generally offer leased line services at a 10% discount to the State tariff rates and market these services to institutional customers through our own dedicated teams and our sales agents.

### ***Sale and Lease of Other Network Elements***

We have substantially completed the construction of our nationwide transmission network. See – Networks- Transmission Network below. We have started to offer some network elements such as optic fibers or fiber channels for lease to other telecommunications operators or corporate customers.

### **Interconnection and Roaming Arrangements**

#### ***Interconnection***

Interconnection refers to various arrangements that permit the connection of our telecommunications networks to other networks. Our cellular and long distance networks interconnect with Unicom Group's cellular networks. Under current arrangements, settlement between Unicom Group and us is based on an internal settlement standard that takes into account either the internal costs of the relevant networks or the government standard applicable between third-party operators, whichever is the more favorable to us.

Unicom Group's cellular networks, our cellular networks and our long distance networks interconnect with the fixed telephone networks of China Telecom, China Netcom and China Railcom. Unicom Group's cellular networks and our cellular networks also interconnect with China Mobile's cellular networks. Our Internet network interconnects with the Internet networks of China Telecom and China Netcom. Although we continue to encounter some difficulties in the execution of our interconnection arrangements with other operators in some service areas, the situation has been improved since 2004 due to improved regulatory supervision by the PRC government in this area.

In October 2003, the MII issued regulations relating to settlement between telecommunications networks. These new regulations contain provisions regarding revenue sharing methods and settlement mechanisms for interconnection arrangements between us and other operators. These interconnection arrangements under the new regulations are described in – Regulatory and Related Matters- Interconnection Arrangements below.

Unicom Group entered into interconnection arrangements with China Telecom, China Netcom and China Mobile with the following agreements, which equally apply to us.

- Framework interconnection and settlement agreement between Unicom Group and the former China Telecom, dated September 30, 2001, the rights and obligations of which were divided and continued after the former China Telecom was split into China Telecom and China Netcom pursuant to an agreement among Unicom Group, China Telecom and China Netcom, dated April 23, 2003. These interconnection and settlement arrangements with China Telecom and China Netcom were superseded by the interconnection and settlement agreement between Unicom Group and China Telecom, dated March 29, 2004 and the interconnection and settlement agreement between Unicom Group and China Netcom, dated April 2, 2004. The 2004 agreements contained more detailed provisions relating to interconnection quality, pursuant to new MII directives in this area.
- Agreement between Unicom Group, China Telecom and China Netcom, relating to the continuation and division of rights and obligations of the parties under Unicom Group's prior interconnection agreement with the former China Telecom, dated April 23, 2003.

- Interconnection and settlement agreements between Unicom Group and China Mobile relating to the interconnection between Unicom Group's GSM and CDMA cellular networks and China Mobile's GSM cellular networks, both dated November 14, 2001, which were amended by the parties on December 31, 2003.
- Interconnection and settlement agreement between Unicom Group and China Mobile regarding the interconnection of point-to-point short messaging services, dated April 1, 2002.
- Interconnection and settlement agreement between Unicom Group and China Mobile regarding the interconnection between China Mobile's GSM cellular networks and Unicom's telecommunications networks, including its local fixed line telephony networks, cellular networks, domestic long distance telephony networks, international telephony networks and IP telephony network, and the interconnection between China Mobile's international gateways and IP telephony network and Unicom Group's cellular networks and local fixed line telephony networks, dated December 31, 2003.
- Agreement between Unicom Group and China Mobile regarding the mutual provision of open service platforms, dated November 5, 2003.

Unicom Group has also entered into the following interconnection arrangements, which equally apply to us.

- Interconnection and settlement agreements between Unicom Group and China Railcom relating to the interconnection of Unicom Group's cellular networks and local fixed line telephony networks and China Railcom's local fixed line telephony networks, domestic long distance networks and IP telephony networks, dated January 25, 2002 and April 9, 2002.
- Supplemental agreements between Unicom Group and China Railcom, which allows each party to offer its domestic and international long distance telephony services and IP telephony services to the cellular or fixed line telephony service subscribers of the other party, dated April 23, 2003.
- Interconnection and settlement agreement between Unicom Group and China Satellite Communications Corp, or China Satcom, relating to the interconnection between Unicom Group's networks and China Satcom's Global Star satellite mobile communications network, dated September 27, 2003.
- Framework interconnection and settlement agreement between Unicom Group and China Satcom relating to the interconnection between Unicom Group's cellular networks and China Satcom's IP telephony networks, dated September 24, 2003.
- Interconnection agreement among major Internet operators, including Unicom Group, and three national Internet switching centers relating to the interconnection of Internet backbone networks, dated December 20, 2001.
- Interconnection and settlement agreement between Unicom Group and China Telecom relating to the provision of point-to-point SMS services between Unicom Group's and China Telecom's networks, dated October 10, 2004.
- Interconnection and settlement agreement between Unicom Group and China Netcom relating to the provision of point-to-point SMS services between Unicom Group's and China Netcom's networks, dated October 11, 2004.



For all interconnection services, we are required to pay the interconnection fees regardless of our ability or inability to collect the tariff from our subscribers. The fixed line operators are required to pay interconnection fees regardless of their ability or inability to collect the tariff from their subscribers. Interconnection charges are accrued on a monthly basis based on the actual call volume and applicable tariff rate. See B. Related Party Transactions Provision of Ongoing Telecommunications and Ancillary Services and Premises Interconnection Arrangements under Item 7 below for the interconnection and settlement arrangements between Unicom Group and us.

### **Roaming**

As of December 31, 2005, our cellular subscribers can roam on cellular networks in Europe, North America and other Asian countries and regions through Unicom Group's international roaming agreements with 248 GSM operators in 118 countries and regions and 18 CDMA operators in 15 countries and regions. Unicom Group has also agreed to arrange for us to participate in its future international roaming arrangements.

A cellular subscriber using roaming services is charged at our roaming usage rate for both incoming and outgoing calls, plus applicable long distance tariffs. Under our roaming agreement with Unicom Group, our subscribers who roam on Unicom Group's networks are charged for each call made or received. We collect this tariff, retain RMB0.20 and pay the remaining amount to Unicom Group. On the other hand, when Unicom Group's subscribers roam on our networks, Unicom Group collects the roaming tariff, retains only RMB0.04 and pays us the remaining amount.

The following table is a summary of roaming settlement between Unicom Group and us:

| <b>For our subscribers roaming on Unicom Group's networks</b> | <b>Roaming Tariff</b> | <b>Paid to Unicom Group</b> | <b>Retained by Us</b> |
|---|-----------------------|-----------------------------|-----------------------|
| GSM pre-paid users (RMB/minute)                               | 0.60                  | 0.40                        | 0.20                  |
| GSM post-paid users (RMB/minute)                              | 0.60                  | 0.40                        | 0.20                  |
| CDMA users (RMB/minute)                                       | 0.60                  | 0.40                        | 0.20                  |

| <b>For Unicom Group's subscribers roaming on our networks</b> | <b>Roaming Tariff</b> | <b>Paid to Us</b> | <b>Retained by Unicom Group</b> |
|---|-----------------------|-------------------|---------------------------------|
| GSM pre-paid users (RMB/minute)                               | 0.60                  | 0.56              | 0.04                            |
| GSM post-paid users (RMB/minute)                              | 0.60                  | 0.56              | 0.04                            |
| CDMA users (RMB/minute)                                       | 0.60                  | 0.56              | 0.04                            |

With respect to international roaming, we settle roaming revenue with international operators through Unicom Group in accordance with roaming agreements between Unicom Group and each of the international operators.

See B. Related Party Transactions Provision of Ongoing Telecommunications and Ancillary Services and Premises Roaming Arrangements under Item 7 below for further information regarding the roaming arrangements between Unicom Group and us.

### **Networks**

We operate an advanced network system to support our integrated operations. The backbone of the system is a nationwide fiber optic transmission network, which serves as the common platform for our cellular, long distance, data and Internet networks. In addition, we continue to develop management and network support systems to enhance the quality and reliability of our networks and improve our customer service and operating efficiency. We generally utilize a centralized network planning and equipment selection process, which ensures uniform nationwide design and network compatibility.

### *Transmission Network*

We own and operate an advanced nationwide fiber optic transmission network (except for the Xizhang Autonomous Region, in which we lease capacity from other operators). As of December 31, 2005, our fiber optic transmission network reached 333 cities with a total cable length of approximately 796,000 km, of which fiber optic backbone transmission network accounted for approximately 122,000 km.

Our fiber optic transmission network is designed for broadband capacity with superior security and reliability, which supports our integrated telecommunications services and allows us to lease capacity to other telecommunications operators and corporate customers. The network deploys:

- synchronous digital hierarchy, or SDH, architecture with protective two- or four-fiber rings, a self-healing system that allows for instantaneous rerouting, automatically protects service circuits and minimizes down time in the event of a fiber cut or equipment malfunction;
- dense wave division multiplexing, or DWDM, technology, a means of increasing transmission capacity by transmitting signals over multiple wavelengths through a single fiber; and
- digital cross connection, or DXC, system, a specialized high-speed data channel exchange and connection system that effectively manages the routing and channeling of our services.

Our SDH fiber rings have transmission bandwidths of 2.5 Gb/s in most routes and 10 Gb/s for the fiber ring that covers the eastern and southern coastal areas of China. We deploy mainly transmission equipment and technology supplied by Siemens, Nortel, Lucent, Alcatel, Huawei, ZTE and other vendors.

Concurrent with the construction and expansion of our domestic backbone transmission network, we also seek to expand our international bandwidth. Through our participation in the Asia Pacific Cable Network No. 2 Project (APCN 2), a trans-pacific submarine cable project that connects major countries and regions in eastern Asia and southeastern Asia and links them to North America through Japan, and our membership in the US-Japan Sub-marine Cable Organization, we are linked with 11 operators in Japan, U.S., South Korea, Singapore and Taiwan with 155x30 Mbps capacity. We also lease 3669 Mbps of international broadband transmission capacity. We have also opened transmission lines on land with the main operators in Hong Kong and Macau, with 15Gbps and 622Mbps of transmission capacity. In addition, we have established fiber-optic interconnections among China, Mongolia and Russia, between China and North Korea and between China and Russia, with transmission capacity of 622Mbps, 622Mbps and 10Gbps, respectively.

As of March 31, 2006, our metropolitan area networks cover 341 cities throughout China, with a total length of approximately 681,000 km. These networks provide a unified, high-speed local transmission platform for our cellular, data and Internet services.

### *Cellular Networks*

A cellular network consists of:

- cell sites, which are physical locations, each equipped with a base station that houses transmitters, receivers and other equipment used to communicate through radio channels with subscribers' cellular handsets within the range of a cell;
- base station controllers, which connect to, and control, the base stations;

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- mobile switching centers, which control the base station controllers and the routing of telephone calls; and
- transmission lines, which link the mobile switching centers, base station controllers, base stations and the public switched telephone network.

We own most of the GSM cellular transmission network at the local and provincial level. We lease a portion of our inter-provincial transmission capacity for our GSM cellular networks as well as the CDMA cellular transmission network. We also use our own backbone fiber optic transmission network to provide transmission capacity for our cellular networks. We continue to focus on the management and operation of our cellular networks.

*GSM Cellular Networks.* The following table sets forth selected information regarding our GSM cellular networks in our service areas as of the dates indicated.

|   | As of December 31, |        |        |
|---|--------------------|--------|--------|
|   | 2003               | 2004   | 2005   |
| Network subscriber capacity (in thousands of subscribers) | 68,050             | 84,552 | 89,461 |
| Base stations   | 56,653             | 81,819 | 94,444 |
| Base station controllers                                  | 1,345              | 1,653  | 1,781  |
| Mobile switching centers                                  | 469                | 477    | 502    |

Currently our GSM cellular network mainly operates at 900 MHz. We have deployed GSM technology that operates at 1800 MHz in some major metropolitan areas to supplement the capacity of our existing cellular network. We have the right to use 6 x 2 MHz of spectrum in the 900 MHz frequency band and 10 x 2 MHz in the 1800 MHz frequency band for our GSM network.

Our cellular networks are supported by an advanced SS7 signaling system, which fosters efficient use of network capacity, reduces call set up time and enhances transmission capabilities. We have also installed intelligent networks that enable us to provide pre-paid services and a wide range of call features and value-added services.

In 2005, we upgraded our GSM networks in Beijing, Shanghai, Guangzhou, Shenzhen, Zhuhai, Dongguan and Suzhou to GPRS networks. In 2006, we plan to expand such upgrade to 50 to 100 major cities in China.

*CDMA Cellular Network.* Unicom Group completed the construction of the first phase of its nationwide CDMA network at the end of 2001. In 2003, Unicom Group completed the second phase of the CDMA network construction, which added an additional capacity of 20.69 million subscribers nationwide and included the upgrade of the network to CDMA 1X technology. The CDMA networks constructed in the second phase did not share as much infrastructure with the GSM network. By the end of 2005, Unicom Group has substantially completed the third phase of the CDMA network construction, adding an additional capacity of approximately 45.69 million subscribers nationwide and significantly improving the coverage and quality of the CDMA network. We lease CDMA network capacity in our cellular service areas and have the exclusive right to operate its network in those areas. We have the right to use 10x2 MHz of spectrum in the 800 MHz frequency band for our CDMA services.

***Long Distance, Data and Internet Networks***

By the end of 2005, our PSTN network reached 333 cities, while the coverage of our Internet networks, including our IP telephony networks, included over 300 cities throughout China.

*Long Distance Network.* Our long distance network is supported by a nationwide billing system and an intelligent network, which allows us to provide multiple services. Our cellular subscribers can access these services directly through our cellular networks, but our other customers typically access our long distance telephony, IP telephony and Internet services through the public switched telephone networks of China Telecom and China Netcom. As of December 31, 2005, the total network capacity for our IP telephony services reached 22,919E1, or a voice capacity of 20 billion minutes per year. E1 is the European format for digital transmission and carries signals at 2Mbps.

*Data and Internet Networks.* Our broadband data and Internet networks utilize a unified IP and ATM design, which is particularly suited for real-time, multimedia applications such as video and voice. ATM switches perform high-speed switching of voice and data traffic and minimize time delay and congestion. They can also prioritize applications that least tolerate time delay, such as telephony and video, over less time-sensitive applications such as e-mails and file transfer. As of December 31, 2005, the international and domestic interconnection bandwidths have reached 4.27Gbps and 17Gbps, respectively.

*Internet Network.* Our Internet network, branded as Uninet, is also centrally designed and has a nationwide uniform architecture. It is supported by a nationwide, advanced billing system that facilitates roaming access and delivery of virtual ISP services and other value added services.

*Broadband Video Network.* Our broadband video network utilizes the H.323 technological standard and two-tier network structure. H.323 is a widely used multi-media conferencing protocol approved by the International Telecommunications Union. As of December 31, 2005, it can provide video conference and video telephone services and currently reaches 330 cities nationwide as well as the United States and Hong Kong.

*Integrated Access Networks.* We believe that the key to the success of our data services is our ability to offer integrated access to customers premises. We are building integrated access networks in many cities throughout China. We focus the construction of our access networks on linking major office buildings to our metropolitan area transmission networks. We rely mainly on fiber optic cables to link office buildings to our networks and have offered narrow-band wireless access at the 3.5 GHz frequency band in approximately 3 municipalities, 18 provincial capitals and 14 provinces.

#### ***Integrated Management and Network Support Systems***

We have developed various management and network support systems to support and manage our various networks. We have established, in each province, municipality or autonomous region, an integrated billing and settlement system that supports the billing and settlement services of our cellular, data and long distance businesses. We have also developed a management support system (MSS) that supports our business support system (BSS) and enterprise resource planning systems (ERP). We have integrated the billing and settlement system and business management system at our headquarters to manage our businesses.

#### **Marketing, Sales and Distribution**

We centrally plan our nationwide marketing and sales strategies, but the implementation of these strategies is carried out at the provincial level by operating branches tailored to their specific markets. In 2005, we focused our marketing strategies on enhancing efficiency and satisfying customer needs.

### *Sales and Marketing*

We focus on developing a strong brand image of "Connecting you freely" that conveys our strengths in high quality services, comprehensive network coverage, integrated solution offerings, advanced technology and customer focus. We market all of our services under the China Unicom brand name. We continued to emphasize brand management in 2005, by implementing a customer-oriented branding system focusing on four customer brands: Worldwind, U-Power, Ruyi Tong and Unicom Horizon. We offer customized service packages under these four customer brands that are targeted to different market segments. Worldwind is our premier customer brand for offering high quality and differentiated services to mid- to high-end individual cellular customers; U-Power is designed for the youth market; Ruyi Tong is targeted to offer mainstream cellular services to individual customers in the mass market; Unicom Horizon focuses on providing industry applications or integrated telecommunication solutions to institutional customers, including corporate, industry and government entities. In addition to the four customer brands, we recently launched two business brands: uni and Unicom Commerce, which are used to market our value-added services to cellular subscribers and long-distance, data and Internet services to primarily institutional customers, respectively.

Our marketing strategy utilizes our image as an integrated telecommunications service provider and leverages on our comprehensive services and nationwide sales and distribution network. By using direct sales forces and sale agents and active market analysis and through sales channels such as service centers, sales outlets and large-scale chain stores, our marketing strategy can be targeted at different customer segments and adjusted timely in accordance with the demands of different markets. In addition, we also seek to enter into strategic alliances in order to further expand the breath and depth of our marketing and sales efforts. In September 2004, we entered into a wireless Internet joint marketing agreement with Intel, HP, IBM, Lenovo and Digital China to develop the industry value chain for our U-Net services based on the CDMA 1X network. In June 2005, the Unicom Group and the Lenovo Group entered into a business cooperation agreement on Lenovo's notebook computers and U-Net business to expand the Palm Broadband business. In December 2005, the Unicom Group entered into a full and exclusive strategic partnership with the Chinese Table Tennis Association to leverage the popularity of table tennis in China to enhance our brand recognition. We expect these arrangements will enhance our marketing ability and promote our brand recognition and our marketing in China.

Moreover, we seek to formulate effective marketing strategies through customer relations management and analysis of customer segmentation, customer demand and consumption trends.

*Customer Segmentation:* We have two main categories of customers: (i) institutional customers, comprised of mainly corporate, industry and government customers, and (ii) individual customers. We have set up dedicated sales and service departments for institutional customers, both at our headquarters and at our provincial and local branches. We focus on promoting our integrated solutions to these institutional customers. For individual customers, we conduct our sales through our own service centers and the retail outlets of independent sales agents.

*Cellular services:* We promote our CDMA services by leveraging our abundant network resources of CDMA network and the technology advantage of CDMA 1X to provide differentiated services targeted at different market segments, including tailoring different service packages for different consumer groups. In 2005, we focused on resolving the bottleneck in CDMA handset supply by strengthening centralized handsets purchasing and implementing marketing strategy of matching handset subsidies with subscribers' committed service fees. We have established Unicom Huasheng to centralize our purchasing of the CDMA handsets in an attempt to lower the entry barrier of our CDMA services caused by high handset price and make the CDMA services more attractive and affordable to the mass market. In addition, by offering a one-stop solution for customers, based on the integrated service capacity of CDMA 1X network technology, we actively pursued integrated services marketing to promote our CDMA 1X services.

We also continued to expand the subscriber base for our GSM voice and value-added services. Our marketing strategies for GSM services focused on the continued development of the voice and SMS services and the rapid expansion of the Cool Ringtone service. We also plan to leverage our newly upgraded GSM networks in selected cities to promote GPRS services.

Recognizing the importance and the needs of our institutional customers and utilizing our advantages of being an integrated telecommunications operator, we formulated marketing strategies for our cellular services that were tailored to our institutional customers. In 2005, we continued to emphasize the development of advanced and customized industrial applications for our institutional customers. By offering industrial solutions, our business extended from the provision of basic telecommunications services to comprehensive value-added information services. For example, we added several applications based on the CDMA 1X network, including Traffic Horizon that provide wireless traffic direction services to CDMA subscribers. We launched in Sichuan province Tianfu Agriculture Information Net , an integrated agriculture information platform supported by our cellular, data and Internet network resources and information resources, which was named the best e-commerce website at the United Nations Summit on Information Society in November 2005.

*Long distance, data and Internet services:* In 2005, we continued to focus on institutional customers, including financial institutions, large corporations, multi-national corporations, government entities and Internet service providers and Internet content providers, in order to provide them customized one-stop solutions. We launched Unicom Commerce to offer integrated telecommunication services specifically designed to cater to institutional customers' needs. Our marketing efforts with respect to retail customers included the marketing of co-branded long distance telephony cards. Under these arrangements, our institutional partners purchased such cards from us and distributed the cards to their employees or customers, thereby facilitating the sale of our long distance telephony services.

*Service Bundling and Cross-Marketing:* A key element of our sales and distribution strategy is to promote our strengths as a provider of a comprehensive range of integrated services. This strategy is implemented by our service centers, independent sales agents and direct sales forces, which distribute and support our various product offerings. For example, we cross-sell our long distance, data and Internet services to our cellular subscribers. In addition, based on the specific demands of our industry and institution clients, we provide customized communications solutions by bundling VPN, IP telephony, Uni-Video broadband video-telephony and U-Net services under the brand Unicom Commerce .

### ***Distribution***

We have a diversified distribution network comprising self-owned sales outlets, agent/distributor sales outlets and direct sales forces. We distribute our services to our individual customers through our self-owned sales outlets as well as other retail outlets. We distribute our services to large customers through our direct sales forces and agents. We have developed a nationwide distribution network of service centers and sales outlets, of which only a small portion are owned by us and the others are owned by independent agents or distributors. As of December 31, 2005, we had a total of approximately 120,000 sales outlets, of which over 6,000 were self-owned. These service centers and retail outlets distribute our cellular, long distance, data and Internet services and provide post-sales services such as service inquiry, customer complaint and collections.

We generally aim to maintain a flat distribution structure, but utilize a multi-level distribution system in some service areas, in which our top-level distributors further distribute to lower level distributors and sales agents. In 2005, we have reduced the levels of such distribution system to control distribution costs. We are also in the process of setting up direct distribution centers to further flatten the distribution structure in some areas. We have also established direct sales and customer service teams to conduct one-on-one sales to high-usage institutional customers. These direct sales and customer service teams focus is to promote our cellular, domestic and international long distance, data and Internet services as integrated telecommunications services in order to provide differentiated and comprehensive solutions for our customers. In 2005, we also expanded the use of new distribution channels such as Internet and telephone marketing.

Our controlling shareholder, Unicom Group, entered into a strategic cooperation arrangement with China Post in 2001. This arrangement allows us to supplement our existing distribution network with China Post's extensive nationwide network. China Post also provides billing, collection and other services to our customers. The arrangement uses a revenue-based commission structure for most services. We and China Post have also agreed to use each other's services and offer each other preferential treatment. We have entered into provincial-level cooperation agreements with China Post in our service areas.

### **Customer Service**

We provide specialized, differentiated and one-stop services to our customers, based on the customer service resources of Unicom Group. In 2006, we launched a uniform service brand of Unicom 10010 to consolidate all customer service resources. Our customer care and service centers in each service area can be accessed by our customers by dialing a nationwide hotline number 10010. Our customer service system is a unified platform providing customer services for all of our businesses. This system is based on the paging centers, and also relies on other systems, including operations, billing, account management and network management. This integrated system allows us to provide personalized and diversified services through customer service representatives or automated systems, including service inquiry, billing inquiry, response to customer complaints and suggestions, service initiation and termination, payment reminder services and emergency services, to different types of customers on a 24-hour basis. Our customers can access our customer services through various means, including telephone calls, faxes, e-mails and SMSs. To better serve our customers, we provide such value-added services as 10011 bill inquiry hotline, 10018 club member service hotline, 13010199999 international roaming service hotline, bill payment through commercial banks, free copies of detailed statements, Internet account inquiry, a single rechargeable card for all of our services and mobile service centers in remote areas of China. To better meet market demand, we continue to seek innovation in our customer services, in order to provide more pro-active, comprehensive and targeted customer services. We also continue to promote customer loyalty through our nationwide club member reward program.

In addition, we also analyze our customer segments in detail, and tailor our services to the requirements of different customer segments. While we are focused on retention of our individual customers, we pay regular visits and provide one-on-one personalized services to our institutional customers and VIP customers and, through customer clubs, provide high-quality and differentiated services for high-net-worth individual customers and important institutional customers. For mass-market customers, we offer standardized services that aim at enhancing customer experience.

We emphasize customer service and customer relations management and have taken various measures to improve customer satisfaction. Such measures include establishing and improving the customer service network, standardizing the content, manner and criteria of service and improving training of customer service representatives. We established our customer service workflow using a consistent set of standards in order to timely resolve problems for our customers. We have also strengthened our analysis and research of customer consumption behavior, consumption cycle and satisfaction levels in order to understand their consumption pattern and influence their consumption trend.



**Billing and Collection**

We are able to leverage our strengths as an integrated service provider to offer integrated billing and collection services to our institutional and individual customers. We also integrate the billing systems for different services and distribute unified recharge cards that can be used to recharge various pre-paid services, including pre-paid cellular services, long distance telephony services and Internet dial-up services. Our billing system can distinguish between customers based on the marketing method and service package plans applicable to each customer. These additional functions would allow us to analyze customer data in more detail, thereby improving our ability to analyze the age of our accounts and control bad debts. The following table sets forth our billing and collection methods for each of our business segments:

| <b>Business Segment</b>               | <b>Billing</b>  | <b>Collection</b>  |
|---------------------------------------|---|--|
| Post-paid GSM and CDMA services       | Centralized at the provincial level and generally by monthly billing.   | Subscribers may pre-deposit their service charges with us or commercial banks or China Post that collect payment for us, make payment in person at our service centers or branches of China Post, or through commercial banks. |
| Pre-paid GSM and CDMA services        | Centralized on our nationwide intelligent network   | Subscribers can purchase and/or re-charge pre-paid cards through various channels. They can also re-charge cards by telephone.   |
| PSTN long distance telephony services | Through nationwide long distance telephony settlement center and regional billing centers located in Beijing, Shanghai and Guangzhou, which coordinates billing with local settlement centers   | Subscribers mainly go to our service centers, commercial banks and branches of China Post for payment.   |
| IP telephony services                 | Through our nationwide data settlement center and various provincial-level settlement systems   | Subscribers mainly go to our service centers, commercial banks and branches of China Post for payment.   |
| Uni-Video services                    | For each corporate customer, billing is either through the local service centers in the locations of the branches of the customer or centralized at one local service center chosen by the corporate customer. Retail customers purchase pre-paid re-chargeable cards for our services. | Our corporate customers can pay either at the local service centers in the locations of the branches of such customer or at one local service center designated by the customer.   |
| Internet services                     | Centralized at the provincial level. Billing methods include monthly billing, volume-based billing and billing according to contractual provisions.   | Subscribers may go to our service centers, commercial banks, and branches of China Post or use the Internet for payment.   |
| Unicom's Internet Plaza               | Customers of the Internet cafes either pay by membership or pay hourly rates.   | N/A  |
| Leased lines                          | Monthly billing in accordance with contractual provisions   | Customers mainly pay at our service centers or at commercial banks.  |



### ***Bad Debt Controls***

*Cellular Services.* Post-paid subscribers must register with us before they can begin using our cellular services. Customer registration allows us to better manage customer credit. If subscribers do not pay their bills on time, we charge a late fee and will either call or send SMSs to the delinquent subscribers to remind them to pay. We generally suspend a post-paid subscriber's account if the account is more than 30 days overdue and terminate the account if it is overdue for more than three months after that. When an account is terminated, we will seek other remedies to collect the overdue payment, including personal visits to the subscriber to collect payments or taking legal actions. At the same time, we encourage our subscribers to pre-deposit service charges with us, to be deducted against charges incurred in the future, or use our pre-paid services. Since 2004, we have developed a customer's credit management system at the provincial branch level to enhance verification of the personal information of new subscribers and tighten credit control for new subscribers. We believe these measures will improve our bad debt control.

*Domestic and International Long Distance Services.* We actively encourage customers to use our pre-paid services. In addition, we perform credit checks on potential customers. For high-volume users, we open telephone banking accounts at commercial banks, set credit limits on such accounts and settle with such customers on a monthly basis.

*Internet services.* We send e-mails to delinquent customers and use other methods to collect payment from delinquent customers. Accounts for individual customers which are delinquent for 20 days are suspended, and such accounts will be terminated if they are delinquent for more than 40 days. For corporate customers, our actions are based on the credit history of each delinquent customer.

### **Research and Development**

We focus on technology innovation in coordination with the various business departments, in order to provide technical support to the development of our various businesses. In 2005, we were granted seven patents from the State Intellectual Properties Bureau of the PRC, including three technology invention patents, one practical patent and three product design patents. We also successfully developed new technology applications such as Tianfu Agriculture Information Online. Major projects of our research and development efforts in 2005 include:

- the tracking and research of the latest technology trends in light of the gradual transition to 3G cellular communications technology and next-generation networks and our position as a provider of integrated services, including participation in the Chinese Next Generation Internet (CNGI) network construction project (led by the National Development and Reform Commission) and the 3G cellular technology testing project (led by the MII);
- the investigation into coordinated development of the GSM and CDMA networks and the transition to next-generation networks, including the development and testing of GSM and CDMA dual-mode handset, the testing of the enhanced CDMA 1X network technology and evolution data optimized technology, the testing of GRPS commercial networks and other research and development of new technologies; and
- the development of new value-added services based on GSM and CDMA networks and new applications for institutional customers.

**Competition**

*The Chinese telecommunications market has six basic telecommunications service providers - China Telecom, Unicom Group, China Mobile, China Netcom, China Satcom and China Railcom - and thousands of value-added service providers. As a relatively new entrant into this highly competitive landscape, we believe the following strengths have contributed to the development and growth of our business in recent years:*

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- *Integrated service offerings and a uniform and advanced telecommunications network* We offer integrated cellular, domestic and international long distance, data and Internet services, and have a nationwide, uniform communications network that support voice, data and Internet communications and allow us to provide integrated services to our customers and utilize our network resources in a cost-effective manner.
- *Unique service offerings* Through our advanced integrated network platform and the implementation of our innovative marketing strategies, we introduced Worldwind CDMA and GSM dual-mode cellular services and a series of value-added services such as CDMA 1X wireless data services, uni value-added services and Unidhorizon industry specific services, in order to satisfy the differentiated demand of our various customer segments.
- *Advanced technologies* CDMA technology offers high bandwidth utilization, better voice quality, high data transmission capabilities, better security, lower handset radio transmitting power, and can be relatively cost-effectively and timely upgraded to 3G cellular telecommunications. We are the only provider for CDMA services in our service areas in China, and our CDMA network has been upgraded to CDMA 1X technology, which has higher data transmission capabilities. Our GSM services utilize 2G technology that is widely accepted internationally and we believe our GSM network coverage and voice quality meet international standards. Our uniform network platform (Unione) utilizes ATM+IP technology solutions to offer quality support to our voice, data, Internet, video conference, video telephony and mobile data services.
- *Professional and quality customer service* Using the customer service resources of Unicom Group, we have built up a strong brand image in customer service that can be characterized as professional, differentiated and one-stop service under our uniform service brand of Unicom 10010 .

However, the development of our business is also affected by certain competitive disadvantages, including:

- *Market position* As a relatively new entrant to the market, we are still behind the traditional operators in such areas as market share and branding. Due to our late entry, we still need to strengthen our market position through expenditures to capture mid- to high-end customers. In addition, we are reliant on the dominant operators in terms of interconnection and settlement.
- *Financial resources* Comparing to the dominant operators such as China Mobile, our capital scale is relatively small, our debt ratio is relatively high, and our share of the market revenue and profit is relatively low.
- *Network coverage and upgrade* While we have made significant improvements in network construction in recent years, network coverage in certain in-door or remote areas still need improvement. In addition, we are still in the process of upgrading our GSM networks to launch GPRS services in selected cities.

### *Cellular Competition*

Our main competitor in the cellular communications business is China Mobile. China Mobile continues to have competitive advantages over us in brand name, market share, financial resources and network management experience. To compete against China Mobile, we continue to improve our network coverage and voice quality, enhance network quality, develop value-added services (such as our CDMA 1X wireless data services), improve customer service and customize our package service plans to meet our various subscribers' specific needs. We also seek to leverage our position as a fully integrated telecommunications operator to provide one-stop telecommunications solutions for our subscribers. In addition, we seek to compete against China Mobile's GPRS wireless data services by the development of our CDMA 1X wireless data services, which offers such advantages as better voice quality, better security, higher data transmission rates and more comprehensive value-added wireless data services. Moreover, we have upgraded our GSM networks in selected cities to offer GPRS wireless data services to our GSM subscribers since 2005.

Our cellular services also compete with the wireless local communications services of China Telecom and China Netcom, known as "Little Smart", which are based on their fixed line networks and primarily utilize PHS technology. These services were previously offered primarily in small- to medium-sized cities, but have been introduced in most cities nationwide. The "Little Smart" services reportedly have attracted a substantial subscriber base in China and compete with us mostly in the lower end of the cellular market. Although many cellular users use "Little Smart" services as a supplement, rather than an alternative, to their existing cellular services, the availability of "Little Smart" services leads to decrease in effective cellular tariffs and reduced the overall usage volume of cellular services. The main competitive advantage of "Little Smart" services is their lower tariff rates. However, they generally have limited network coverage and roaming capability.

In addition, we expect that the PRC government's decision in respect of the 3G licenses may significantly change the overall competition environment of the PRC wireless telecommunication industry and could further intensify the competition among cellular service providers. See **D. Risk Factors - Risks Relating to Our Business**. Our cellular businesses face intense competition from China Mobile, China Telecom and China Netcom. Such competition may result in slower subscriber growth, lower tariffs and higher customer acquisitions costs for us, which would materially adversely affect our financial condition, results of operation and growth prospects and Issuance of additional telecommunication service licenses including 3G licenses, may further intensify competition in the PRC telecommunication industry and materially adversely affect our financial condition, results of operations and growth prospects under Item 3.

Since the launch of our CDMA cellular services in 2002, we have pursued a strategy of coordinated development of our GSM and CDMA cellular businesses. In 2005, the majority of our CDMA new subscribers were users migrating from the GSM services of our competitor, first-time cellular users, and users who previously subscribed to our GSM services. See **D. Risk Factors - Risks Relating to Our Business**. Our CDMA services may not succeed in gaining a broader market acceptance in China. under Item 3.

### *Long Distance Telephony Competition*

China Telecom and China Netcom are the dominant providers and our primary competitors in the public switched long distance business in their respective service areas. They have advantages over us in their respective service areas in brand name, market share, financial resources, service area coverage, last-mile access, extensive access networks and experience in fixed line telecommunications business. However, the separation of China Telecom into two companies along geographic lines weakened the competitiveness of the resulting entities on a nationwide basis.

Since our network has been constructed recently and is equipped with the latest technology and advanced features, it enables us to offer a variety of high-quality services. Our long distance telephony services are also supported by a centralized billing system. However, our services are hindered by our lack of fixed line telephone number resources and last-mile access.

Since the MII deregulated the tariffs of this market in 2001, competition in the IP telephony market has been intensifying. Our IP telephony services currently face intense competition from China Telecom, China Netcom, China Mobile, China Railcom and China Satcom. Currently, China Telecom and China Netcom are the market leaders in their respective service areas.

#### ***Data and Internet Competition***

China Telecom and China Netcom are our major competitors in the data services business in their respective service areas. Other competitors include China Railcom and China Satcom. While China Telecom, China Netcom, China Railcom, China Mobile, China Satcom and we are the only Internet backbone operators in China, there are many retail Internet service providers throughout China. China Telecom and China Netcom have leading positions in the Internet access market and are the largest wholesale Internet service providers in their respective service areas. Our data and Internet networks have nationwide access, which offers convenience and flexibility to our institutional customers, whereas the respective networks of China Telecom and China Netcom only extend to their respective service areas.

The advanced features and design of our backbone network allow us to provide nationwide high quality virtual private network services, which are specifically tailored to the high-usage corporate customers and retail Internet service providers that we target. We are also building advanced metropolitan area networks and integrated access networks that allow us to connect to key commercial buildings throughout China. We also continue to cooperate with medium- to small-sized Internet service providers and other companies that have broadband access to concentrated residential areas to expand our broadband services.

#### **Trademarks**

We conduct our businesses under the Unicom name and logo. Unicom Group is the registered proprietor in China of the Unicom trademark in English and the trademark bearing the Unicom logo. Unicom Group has also applied and became the registered proprietor of the trademark of the word Unicom in Chinese. Unicom Group has granted us the right to use these trademarks on a royalty-free basis, and to license to us any trademark that it registers in China in the future which incorporates the word Unicom.

In March 2006, we replaced our logo to promote a more friendly and internationalized corporate image. The new logo uses a combination of Chinese red and Chinese ink black. The red stands for passion, enthusiasm and energy while the ink black stands for cohesion, steadiness and elegance.

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

The telecommunications industry in China is subject to a high degree of government regulation. The primary regulatory authority of the Chinese telecommunications industry is the MII. The State Council, the National Development and Reform Commission (the successor of the former State Development Planning Commission), or the NDRC, the Ministry of Commerce (formerly, the Ministry of Foreign Trade and Economic Cooperation) and other governmental authorities also maintain regulatory responsibilities over certain aspects of the Chinese telecommunications industry.

The MII, under the supervision of the State Council, 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 number resources,
- 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.

The MII has established a Telecommunications Administration Bureau in each province, which is mainly responsible for enforcement of telecommunications policies and regulations in that province.

The MII is in the process of drafting a telecommunications law that, once adopted by the National People's Congress, will become the basic telecommunications statute and provide the principal legal framework for telecommunications regulations in China. It is currently uncertain when the law will be adopted and become effective.

#### ***Telecommunications Regulations***

The 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 existing rules and policies for the telecommunications industry. They provide the current primary regulatory framework for China's telecommunications industry in the interim period prior to the adoption of the proposed telecommunications law.

The Telecommunications Regulations are intended to develop a transparent and fair regulatory environment to foster orderly competition and encourage development in the telecommunications industry. The Telecommunications Regulations address all key aspects of the telecommunications industry, including entry into the industry, scope of business, tariff setting, interconnection arrangements, quality of services, technology standards and allocation of telecommunications resources.

#### ***Entry into the Industry***

The Telecommunications Regulations adopt the existing regulatory distinction between basic and value-added telecommunication services. An addendum to the Telecommunications Regulations sub-categorizes basic and value-added telecommunication services. In February 2003, the MII revised the addendum to the Telecommunications Regulations; and the revised addendum took effect in April 2003. Basic telecommunications services include, among others, fixed line local and domestic long distance telephony services, international telecommunications services, IP telephony services, mobile voice and data services, Internet and other public data transmission services, lease or sale of network elements, and paging services. Value added telecommunications services include, among others, e-mail, voice mail, electronic data interchange, Internet access, Internet content and video conferencing services.

The MII promulgated Measures on the Administration of Telecommunication Business Licenses, which took effect on January 1, 2002. Those rules apply to the application for, examination and approval of, telecommunications business licenses in China. Providers of any basic telecommunications services as well as providers of value-added services in two or more provinces autonomous regions and municipalities in China must apply for licenses from the MII. Licenses for basic telecommunications services will be granted through a tendering process.



After its accession to the WTO in December 2001, China promulgated the Administrative Regulations on Telecommunications Companies with Foreign Investment, effective on January 1, 2002, implementing its commitments to the WTO. Those commitments include the gradual reduction of foreign ownership restrictions in the telecommunications industry and the step-by-step opening of the telecommunications market in China to foreign operators. However, the presence or absence of foreign investments in an applicant for telecommunications licenses will presumably bear no direct relation to the decision on whether to issue licenses, in as much as the issuance of new licenses is governed by a separate set of rules and regulations. The specific market-opening commitments China made to the WTO regarding, mobile services, value-added telecommunication services and fixed line services are as follows.

- For mobile voice and data services:
  - Upon accession: foreign service providers will be permitted to establish joint venture enterprises and provide services in and between the cities of Shanghai, Guangzhou and Beijing; foreign ownership in such joint ventures shall be no more than 25%;
  - Within one year after accession: the services areas will be expanded to include services in and between the additional 14 cities; foreign ownership shall be no more than 35%;
  - Within three years after accession: foreign ownership shall be no more than 49%; and
  - Within five years after accession: there will be no geographic restriction and the foreign ownership shall be no more than 49%.
- For value-added telecommunication services:
  - Upon accession: foreign service providers will be permitted to establish joint venture enterprises and provide services in and between the cities of Shanghai, Guangzhou and Beijing; foreign ownership in such joint ventures shall be no more than 30%;
  - Within one year after accession: the services areas will be expanded to include services in and between the additional 14 cities; foreign ownership shall be no more than 49%; and
  - Within two years after accession: there will be no geographic restriction, foreign ownership shall be no more than 50%.
- For fixed line services:
  - Within three years after accession: foreign service providers will be permitted to establish joint venture enterprises and provide services in and between the cities of Shanghai, Guangzhou and Beijing; foreign ownership in such joint ventures shall be no more than 25%;
  - Within five years after accession: the services areas will be expanded to include services in and between an additional 14 cities of Chengdu, Chongqing, Dalian, Fuzhou, Hangzhou, Nanjing, Ningbo, Qingdao, Shenyang, Shenzhou, Xiamen, Xi'an, Taiyuan and Wuhan, or, the additional 14 cities; foreign ownership shall be no more than 35%; and
  - Within six years after accession: there will be no geographic restriction and foreign ownership shall be no more than 49%.

### *Spectrum and Network Number Resources*

The MII allocates all telecommunications-related frequencies, including those used in cellular, paging and microwave operations. The 800 MHz, 900 MHz and 1,800 MHz frequency bands have been reserved for mobile cellular applications and parts of the 150 MHz and 280 MHz frequency bands have been reserved for paging applications. The frequency assigned to a licensee may not be leased or transferred without obtaining the approval of the MII.

Since July 1, 2002, the standard spectrum usage fees for GSM networks and CDMA networks has been charged based on actual usage at an annual rate of up to RMB15 million per MHz of frequency (upward and downward frequencies are charged separately) progressively over a period of three years and a period of five years, respectively. The current allocation of spectrum usage fees between Unicom Group and us based on the number of subscribers remains unchanged.

The MII is also responsible for the administration of network number resources within China, including cellular network numbers and subscriber numbers. In January 2003, it issued the Administrative Rules for Telecommunications Network Numbers, which took effect on March 1, 2003. According to these rules, the telecommunications network number resources are properties of the PRC government, and the use of number resources by any telecommunications operator is subject to the approval of MII. Users of number resources, including us, are required to pay a usage fee to the PRC government. The rules also provide for procedures for application for the use, upgrade and adjustment of number resources by telecommunications operators.

In December 2004, the MII, the Ministry of Finance and the NDRC jointly issued the Provisional Administrative Measures with respect to the Collection of the Usage Fee of Telecommunications Network Number Resources, under which telecommunications companies are required to pay a usage fee to the PRC government by the 10th day of the first month of each quarter starting from 2005. Under these provisional measures, mobile telecommunications companies are required to pay an annual usage fee of RMB12 million for each network number. In addition, we are also required to pay usage fees for certain other network numbers totaling approximately RMB6 million a year. We are required to start paying usage fees in 2005. In 2005, the usage fees we paid to the PRC government totaled RMB40.67 million.

### *Tariff Setting and Price Controls*

The levels and categories of our current tariffs are subject to regulation by various government authorities, including the MII, the NDRC, and, at the local level, the relevant provincial Telecommunications Administration Bureaus and price regulatory authorities. Under the Telecommunications Regulations, telecommunications tariffs are categorized into State-fixed tariffs, State-guidance tariffs and market-based tariffs. For example, there are State-guidance tariffs for cellular services, fixed line telephony services and leased lines services that are set jointly by the MII and the NDRC. Tariffs for telecommunications services where adequate competition has already developed may be set by the service providers as market-based tariffs. The government is required to hold public hearings before setting or changing important State-tariff rates, which are attended by telecommunication operators, consumers and others. Operators are required to provide complete and adequate cost data and other materials for those hearings.

In 1997, the PRC government granted us preferential treatment by allowing us to vary our cellular tariffs by up to 10% from the state-guidance rates.

In December 2000, the MII, the former State Development Planning Commission and the Ministry of Finance jointly issued a tariff adjustment circular, which provides for tariff adjustments for a wide range of telecommunications services. Effective from February 21, 2001, we have adopted these government tariff adjustments.

In June 2003, the Ministry of Finance and the MII jointly issued a circular to revoke certain fees including one-time installation fees charged to the fixed line telephone users and one-time activation fees charged to the cellular subscribers.

In June 2004, the MII and the NDRC jointly issued a notice aimed at further strengthening the regulatory oversight of telecommunications tariffs. The notice requires telecommunications services providers to strengthen their internal control and management of tariff setting activities. Specifically, the notice requires services providers to strictly comply with the relevant government regulation relating to the procedures for the approval and registration of telecommunications tariffs.

In August 2005, the MII and NDRC jointly issued a notice stipulating that, with the exception of IP telephony services, maximum charges for many telecommunications services may not exceed the current level of charges.

**Interconnection Arrangements**

In 1999, the MII issued provisional regulations on interconnection and settlement arrangements. These regulations contain specific provisions regarding, among other things, revenue sharing methods and settlement mechanisms and interconnection agreements among telecommunications service providers. The Telecommunication Regulations reaffirmed the obligations of dominant telecommunications operators in China to provide interconnection with other operators. The MII adjusted the interconnection revenue sharing and settlement arrangements, effective from March 21, 2001, and further adjusted them on October 28, 2003. We have entered into interconnection and settlement agreements with China Telecom, China Netcom, China Mobile and China Railcom that implement the regulatory requirements.

The following table sets forth our interconnection revenue sharing and settlement arrangements with fixed line operators and China Mobile for local calls after the regulatory adjustment in 2003.

| Network from which calls originated             | Network at which calls terminated               | Settlement Arrangement (under 2003 regulations)   |
|---|---|---|
| Unicom's cellular network                       | Fixed line operators' public fixed line network | (1) Unicom collects the local cellular usage charge from its subscribers<br>(2) Unicom pays RMB0.06 per minute to fixed line operators            |
| Fixed line operators' public fixed line network | Unicom's cellular network                       | No revenue sharing or settlement  |
| Unicom's cellular network                       | China Mobile's cellular network                 | (1) Each of Unicom and China Mobile collects the cellular usage charge from its subscribers<br>(2) Unicom pays RMB0.06 per minute to China Mobile |
| China Mobile's cellular network                 | Unicom's cellular network                       | (1) Each of Unicom and China Mobile collects the cellular usage charge from its subscribers<br>(2) China Mobile pays RMB0.06 per minute to Unicom |

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The following table sets forth our interconnection revenue sharing and settlement arrangement with fixed line operators and China Mobile for domestic long distance calls after the regulatory adjustment in 2003.

| Network from which calls originated                       | Network at which calls terminated   | Settlement Arrangement (under 2003 regulations)  |
|---|---|--|
| Unicom's cellular network at area A                       | Fixed line operators' public fixed line network at area B, if through the long distance network of such fixed line operator | <p>(1) Unicom collects the domestic long distance tariff and local call tariff from its subscribers</p> <p>(2) Unicom keeps RMB0.06 per minute and pays the rest of the domestic long distance tariff to fixed line operators</p>  |
| Unicom's cellular network at area A                       | Fixed line operators' public fixed line network at area B, if through the long distance network of Unicom                   | <p>(1) Unicom collects the domestic long distance tariff and local call tariff from its subscribers</p> <p>(2) Unicom pays RMB0.06 per minute to fixed line operators, and keeps the rest of the domestic long distance tariff</p>   |
| Fixed line operators' public fixed line network at area A | Unicom's cellular network at area B, if through the long distance network of Unicom   | <p>(1) Fixed line operators collect the domestic long distance tariff from their subscribers</p> <p>(2) Fixed line operators keep RMB0.06 per minute and pay the rest to Unicom</p>  |
| Fixed line operators' public fixed line network at area A | Fixed line operators' public fixed line network at area B, if through the long distance network of Unicom                   | <p>(1) Fixed line operators on the originating end collect the domestic long distance tariff from their subscribers</p> <p>(2) Fixed line operators keep RMB0.06 per minute and pay the rest to Unicom</p> <p>(3) Unicom then pays RMB0.06 per minute to fixed line operators on the receiving end</p> |
| Unicom's cellular network at area A                       | China Mobile's cellular network at area B, if through the long distance network of China Mobile                             | <p>(1) Unicom collects the domestic long distance tariff and local call tariff from its subscribers</p> <p>(2) Unicom keeps RMB0.06 per minute and pays the rest of the domestic long distance tariff to China Mobile</p>  |
| China Mobile's cellular network at area A                 | Unicom's cellular network at area B, if through the long distance network of Unicom   | <p>(1) China Mobile collects the domestic long distance tariff and local call tariff from its subscribers</p> <p>(2) China Mobile keeps RMB0.06 per minute and pays the rest of the domestic long distance tariff to Unicom</p>  |

The following table sets forth our interconnection revenue sharing and settlement arrangement with fixed line operators for international long distance calls through their international gateways after the regulatory adjustment in 2003.



| Type of calls   | <b>Settlement Arrangements<br/>(under 2003 regulations)</b>  |
|---|--|
| Outgoing calls from Unicom's cellular network, if through the international long distance network of fixed line operators | (1) Unicom collects the international long distance tariff and local call tariff from its subscribers<br>(2) Unicom keeps RMB0.06 or RMB0.54 per minute (depending on whether through Unicom's domestic long distance network) and pays the rest of the international long distance tariff to fixed line operators |
| Incoming calls to Unicom's cellular network, if through the international long distance network of fixed line operators   | (1) Unicom receives RMB0.06 or RMB0.54 per minute from fixed line operators (depending on whether through Unicom's domestic long distance network)   |

The following table sets forth our interconnection revenue sharing and settlement arrangements with other operators for IP telephony long distance calls through our network after the regulating adjustment in 2003.

| Network from which calls originated                          | <b>Network at which calls terminated</b>  | <b>Settlement Arrangement<br/>(under 2003 regulations)</b>   |
|--|---|--|
| Unicom's cellular network at area A                          | Other operators' public telecommunications network at area B (if through Unicom's IP telephony network) | (1) Unicom collects the IP telephony long distance charges and local call tariff from its subscribers<br><br>(2) Unicom pays RMB0.06 per minute to other operators on the receiving end  |
| Other operators' public telecommunications network at area A | Other operators' public telecommunications network at area B (if through Unicom's IP telephony network) | (1) Unicom collects the IP telephony long distance charges from its subscribers<br><br>(2) Unicom pays RMB0.06 per minute to other operators on the receiving end<br><br>(3) No settlement between Unicom and other operators on the originating end |

For all interconnection services, we are required to pay the interconnection fees regardless of our ability or inability to collect the tariff from our subscribers. The fixed line operators are required to pay interconnection fees regardless of their ability or inability to collect the tariff from their subscribers. Interconnection charges are accrued on a monthly basis based on the actual call volume and applicable tariff rate.

*Technical Standards*

The MII sets industry technical standards for the Chinese telecommunications industry. Most of the standards set by the MII conform to the standards recommended by the International Telecommunications Union and other international telecommunications standards organizations. In cases where the MII has not set certain industry technical standards, we set our own enterprise technical standards. The MII also requires all network operators in China to purchase only telecommunications equipment certified by the MII, including cellular and paging equipment, radio equipment and interconnection terminal equipment.

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### *Universal Services*

Telecommunications service providers in China are required to fulfill universal service obligations in accordance with relevant regulations to be promulgated by the PRC government, and the MII has the authority to delineate the scope of its universal service obligations. The MII may also select universal service providers through a tendering process. The MII, together with the 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. The MII and other relevant government authorities are still in the process of formulating the detailed regulations relating to the provision of such universal services. Such regulations, if promulgated, may require us to incur significant expenses to fulfill our universal service obligations and therefore could materially adversely affect our financial condition and results of operations.

The MII has required major Chinese telecommunication service providers, including Unicom Group, to participate in a project to provide telecommunications services in a number of remote villages in certain designated provinces in China as transitional measures prior to the formalization of a universal service obligation framework. In participating in such project, Unicom Group undertook the universal service obligation to extend telecommunication service coverage to a total of more than 4,600 administrative-level villages in 2004 and 2005 primarily through its CDMA and satellite transmission networks. In 2006, Unicom Group is required to extend telecommunication service coverage to more than 1,500 additional villages in remote areas. We have been assisting Unicom Group in providing mobile telecommunication services to these remote villages and are responsible for the operation and maintenance of the relevant network facilities in our service areas.

See D. Risk Factors Risks Relating to the Overall Telecommunications Industry in China. The PRC government may require us, along with other telecommunication service providers in China, to provide universal services with specified obligations, and we may not be compensated adequately for providing such services. under Item 3.

### *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, the investment projects that require the approval of the NDRC include:

- domestic backbone transmission networks (including broadcasting and television networks);
- international telecommunications transmission circuits;
- international gateways;
- international telecommunications facilities for dedicated telecommunications networks; and
- other telecommunications infrastructure projects involving information security.



**Others**

As a company with substantially all of our operations in China, we, along with our controlling shareholder, Unicom Group, are subject to various regulations of the PRC government in addition to those regulating the telecommunications industry. PRC regulatory authorities, such as the State Bureau of Taxation, National Audit Office, State Administration of Industry and Commerce and local price bureaus, exercise extensive control over various aspects of our businesses and conduct various regular inspections, examinations and/or audits on us and Unicom Group. As required by the relevant PRC laws and regulations, Unicom Group, as one of the key State-owned enterprises under the direct supervision of the SASAC, is also subject to routine audits by the National Audit Office, or the NAO, including the senior management departure audit which involves a mandatory review by the NAO of the economic responsibilities of a departing senior management member of Unicom Group.

In 2004, the NAO conducted a senior management departure audit of Unicom Group after the resignation of Mr. Yang Xian Zu, Unicom Group's former Chairman, in 2003. We understand that the results of that audit had no material adverse effect on our company.

In 2005, the NAO conducted another senior management departure audit of Unicom Group after the resignation of Mr. Wang Jianzhou, Unicom Group's former Chairman, in 2004. We understand that the results of that audit had no material adverse effect on our company.

In addition, as our controlling shareholder, Unicom Group under the direct supervision of SASAC, SASAC has an indirect influence over us. In particular, SASAC may designate certain nominees and request Unicom Group to propose the appointment of such nominees as our directors and senior management; SASAC may also request Unicom Group to remove our directors and senior management in accordance with relevant procedures provided by applicable law and our articles of association.

**C. Organizational Structure**

We are incorporated in Hong Kong and are 52.36% indirectly owned by the Unicom Group and 47.64% owned by public shareholders as of May 31, 2006. See A. History and Development of the Company under Item 4. Set forth below are details of our significant subsidiaries:

| Name of Subsidiary                   | Country of Incorporation | Ownership Interest |   |
|--------------------------------------|--------------------------|--------------------|---|
| China Unicom Corporation Limited     | China                    | 100                | % |
| China Unicom International Limited   | Hong Kong SAR            | 100                | % |
| China Unicom (Macau) Company Limited | Macau SAR                | 100                | % |

**D. Properties**

Our principal executive offices are located in Hong Kong. We also maintain executive offices in Beijing. We own and lease a large number of offices, retail outlets, equipment rooms and base stations throughout China. Some of the properties we lease and operate on do not have land use rights certificates or building ownership certificates. In some cases, we have not entered into formal lease agreements with the lessors or the lessors do not possess requisite title certificates. We believe that it is unlikely that we would be denied our right to use a large number of these properties at any given time. Our controlling shareholder, Unicom Group, has agreed to indemnify us against any loss or damages incurred by us that are caused by or arising from any challenge of, or interference with, our right to use these properties.

**Item 4A. Unresolved Staff Comments**

None.

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

You should read the following discussion and analysis together with the selected financial data set forth in Item 3 and the consolidated financial statements included in this annual report. The financial statements have been prepared in accordance with HKFRS, which differ in certain respects from US GAAP. Note 37 to the consolidated financial statements summarizes the nature and effects of significant differences between HKFRS and US GAAP as they relate to our financial statements and provides a reconciliation to US GAAP of our net income and shareholders equity. In addition, Note 37 to our consolidated financial statements includes our condensed consolidated financial information prepared and presented in accordance with US GAAP for the relevant periods. Our consolidated financial statements present, and the discussion and analysis under this Item 5 pertain to, our consolidated financial position and results of operations as of December 31, 2004 and 2005 and for the years ended December 31, 2003, 2004 and 2005. On December 31, 2002 and 2003, we completed the acquisition of Unicom New Century from Unicom Group, and the acquisition of Unicom New World from Unicom Group and sale of Guoxin Paging to Unicom Group, respectively.

Our consolidated financial statements as of and for the year ended December 31, 2004 reflect the results of operations of both Unicom New Century (which was merged into CUCL in July 2004) and Unicom New World (which was merged into CUCL in September 2005), but do not include the results of operations of Guoxin Paging. Our consolidated financial statements for the year ended December 31, 2003 reflect the results of operations of Unicom New Century and Guoxin Paging but do not include the results of operations of Unicom New World. In addition, in September 2004, we completed the acquisition of Unicom International from Unicom Group. Accordingly, the operating results of Unicom International for the period from the effective date of the acquisition to December 31, 2004 have been included in our consolidated statement of income for the year ended December 31, 2004. See Acquisitions of Unicom New Century, Unicom New World and Unicom International and the Sale of Guoxin Paging below.

Our financial statements are prepared in accordance with HKFRS, which became effective on January 1, 2005. Prior to January 1, 2005, our financial statements were prepared in accordance with HK GAAP. The adoption of HKFRS resulted in changes in certain accounting policies which have been reflected in the financial statements either in accordance with the transitional provisions in the applicable accounting standards or, to the extent there are no transitional provisions, applied retrospectively. Accordingly, the comparative financial data prior to January 1, 2005 presented in this annual report have been restated to conform, as applicable, to the changed accounting policies. A detailed description is set forth in Note 2.2 to our consolidated financial statements.

**Overview**

We are an integrated provider of telecommunications services in China and offer a comprehensive range of telecommunications services, including the following, which also constitute our major operating segments:

- GSM cellular service in 21 provinces, 5 autonomous regions and 4 municipalities;
- CDMA cellular service in 21 provinces, 5 autonomous regions and 4 municipalities of China and in Macau;
- domestic and international long distance service nationwide in China; and
- data and Internet and other related services nationwide in China.

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The table below sets forth revenue from our major businesses and the respective percentage of our total revenue in 2003, 2004 and 2005.

|  | For the year ended December 31,<br>2003 (Restated)(1) |                       | 2004 (Restated)(1) |                       | 2005               |                       |  |  |
|--|---|-----------------------|--------------------|-----------------------|--------------------|-----------------------|--|--|
|  | RMB in<br>millions                                    | % of Total<br>Revenue | RMB in<br>millions | % of Total<br>Revenue | RMB in<br>millions | % of Total<br>Revenue |  |  |
| Total revenue                          | 67,154  | 100.0 %               | 79,087             | 100.0 %               | 87,049             | 100.0 %               |  |  |
| Total service revenue                  | 64,933  | 96.7 %                | 77,397             | 97.9 %                | 84,287             | 96.8 %                |  |  |
| GSM                                    | 41,153  | 61.3 %                | 47,509             | 60.1 %                | 52,135             | 59.9 %                |  |  |
| CDMA                                   | 16,667  | 24.8 %                | 24,377             | 30.9 %                | 27,577             | 31.7 %                |  |  |
| Long distance revenue                  | 2,273   | 3.4 %                 | 1,848              | 2.3 %                 | 1,525              | 1.7 %                 |  |  |
| Data and Internet revenue              | 3,437   | 5.1 %                 | 3,663              | 4.6 %                 | 3,050              | 3.5 %                 |  |  |
| Paging                                 | 1,403   | 2.1 %                 |                    | 0.0 %                 |                    | 0.0 %                 |  |  |
| Sales from telecommunications products | 2,221   | 3.3 %                 | 1,690              | 2.1 %                 | 2,762              | 3.2 %                 |  |  |

(1) The adoption of HKFRS on January 1, 2005 resulted in changes in certain accounting policies which have been reflected in the financial statements either in accordance with the transitional provisions in the applicable accounting standards or, to the extent there are not transitional provisions, applied retrospectively. Accordingly, the comparative financial data prior to January 1, 2005 presented herein have been restated, as applicable, to conform to the changed accounting policies. See Note 2.2 to our consolidated financial statements included in this Form 20-F for detailed discussion.

Our service revenue comes primarily from the following:

- Usage fees for our GSM, CDMA, long distance and data and Internet services, including, for our cellular subscribers, roaming-out fees for calls made by them outside their local service areas. We recognize usage fee revenue when the service is rendered.
- Monthly fees, of fixed amounts, charged to certain of our GSM, CDMA, data and Internet subscribers for access to the relevant service. We recognize monthly fee revenue in the month during which the services are rendered.
- Other revenue primarily from the provision of valued-added services, such as short message services, personalized call-back ring tone services, CDMA1X wireless data services and certain receptionist services to subscribers.
- Interconnection revenue from other telecommunications operators, including Unicom Group, for calls made from their networks to our networks and roaming-in fees for calls made by cellular subscribers of other operators using our cellular networks. We recognize interconnection revenue when the relevant calls are made by subscribers.
- Rental income from leases of transmission lines on our networks and indefeasible rights of use ( IRU ) to Unicom Group, business customers and other telecommunications carriers in China. We recognize leased line rental revenue on a straight-line basis over the relevant lease term, except for the lease of specific and identified network assets that transfer substantially all the risks and rewards incidental to ownership to the lessee, which is recognized as capacity sales.
- Sales of telecommunication calling cards, representing pre-paid service fees, are recorded as advances from customers and recognized as revenue when the service is rendered upon actual use of the cards.

Along with the continued growth of China's telecommunications industry, particularly in the cellular communications sector, our total revenue in 2005 increased by 10.1% from 2004. This increase was primarily the result of the continued growth in revenue of our GSM and CDMA cellular businesses. Service revenue from our cellular businesses has increased from RMB71,886 million in 2004 to RMB79,712 million in 2005, representing a growth of 10.9%. We aim to further leverage our position as an integrated telecommunications operator in order to continue to drive the growth of our GSM and CDMA cellular businesses as well as long distance, data and Internet businesses.



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The following table sets forth our major costs and expenses items and income before income tax, both in terms of amount and as a percentage of total revenue in 2003, 2004 and 2005.

|   | For the year ended December 31, |            |   |                 |            |   |          |            |   |
|---|---------------------------------|------------|---|-----------------|------------|---|----------|------------|---|
|   | 2003 (Restated)                 |            |   | 2004 (Restated) |            |   | 2005     |            |   |
|   | RMB in                          | % of Total |   | RMB in          | % of Total |   | RMB in   | % of Total |   |
|   | millions                        | Revenue    |   | millions        | Revenue    |   | millions | Revenue    |   |
| Total Revenue   | 67,154                          | 100.0      | % | 79,087          | 100.0      | % | 87,049   | 100.0      | % |
| Costs and expenses  | 60,956                          | 90.8       | % | 72,616          | 91.8       | % | 79,947   | 91.8       | % |
| Leased line and network capacities                        | 4,320                           | 6.4        | % | 7,398           | 9.4        | % | 8,748    | 10.0       | % |
| Interconnection charges                                   | 5,921                           | 8.8        | % | 7,517           | 9.5        | % | 8,372    | 9.6        | % |
| Depreciation and amortization                             | 16,359                          | 24.4       | % | 19,011          | 24.0       | % | 20,368   | 23.4       | % |
| Employee benefit expenses                                 | 4,596                           | 6.8        | % | 4,615           | 5.8        | % | 5,616    | 6.5        | % |
| Selling and marketing                                     | 15,264                          | 22.7       | % | 19,523          | 24.7       | % | 20,558   | 23.6       | % |
| General, administrative and other expenses                | 9,139                           | 13.7       | % | 10,500          | 13.3       | % | 11,742   | 13.5       | % |
| Cost of telecommunications products sold                  | 2,939                           | 4.4        | % | 2,563           | 3.2        | % | 3,575    | 4.1        | % |
| Loss on sale of discontinued operation<br>(Guoxin Paging) | 663                             | 1.0        | % |                 | 0.0        | % |          | 0.0        | % |
| Finance costs   | 1,946                           | 2.9        | % | 1,696           | 2.1        | % | 1,099    | 1.2        | % |
| Interest income   | -173                            | -0.3       | % | -103            | -0.1       | % | -96      | -0.1       | % |
| Other gains, net  | -18                             | 0.0        | % | -104            | -0.1       | % | -35      | 0.0        | % |
| Income before income tax                                  | 6,198                           | 9.2        | % | 6,471           | 8.2        | % | 7,102    | 8.2        | % |

Our major costs and expenses include the following:

- Selling and marketing expenses, including commissions, promotion and advertising expenses, amortization of capitalized customer acquisition costs of certain CDMA contractual subscribers and customer retention costs;
- Depreciation and amortization expenses, mainly relating to our property, plant and equipment and other assets;
- General, administrative and other expenses, primarily including operating lease expenses, repair and maintenance costs, provision for doubtful debts and provisions for impairment in the value of property, plant and equipment. Other components of general, administrative and other expenses include utilities, general office expenses and travel expenses;
- Leased line and network capacities charges, representing lease expenses for transmission capacity from other operators and CDMA network capacities from Unicom Group;

- Interconnection expenses, representing amounts paid to other operators, including Unicom Group, for calls from our networks to their networks and roaming-out fees paid to other operators, including Unicom Group, for calls made by our subscribers roaming in their networks;
- Employee benefit expenses, representing staff salaries and wages, bonuses and medical benefits, contributions to defined contribution pension schemes and housing benefits, share-based compensation cost amortized over the vesting period of share options; and
- Costs of telecommunications products sold.

As we continue to aim to strengthen management, integrate our businesses and control costs to achieve greater overall efficiency, total costs and expenses, as a percentage of total revenue in 2005, was maintain at 91.8%, the same as that in 2004.

***Acquisitions of Unicom New Century, Unicom New World and Unicom International and the Sale of Guoxin Paging***

In December 2002, we acquired from Unicom Group the GSM cellular assets and businesses and CDMA businesses of Unicom New Century in the following six provinces, two autonomous regions and one municipality in China: Sichuan, Heilongjiang, Jilin, Henan, Jiangxi, Shaanxi, Chongqing, Guangxi and Xinjiang. The total purchase price was HK\$4,909,000,000 (approximately RMB4.8 billion), payable in cash. On July 30, 2004, Unicom New Century was merged into CUCL and legally dissolved upon the completion of such merger.

In December 2003, we acquired from Unicom Group the GSM cellular assets and businesses and CDMA businesses of Unicom New World in the following nine provinces and autonomous regions in China: Shanxi, Hunan, Hainan, Yunnan, Gansu and Qinghai provinces and Inner Mongolia, Ningxia Hui and Xizang autonomous regions. The total purchase price was HK\$3,014,886,000 (approximately RMB3.2 billion), payable in cash. On the same date, we also completed the sale of the entire equity interests of Guoxin Paging to Unicom Group for a total sale price of HK\$2,590,917,656 (approximately RMB2.75 billion), and such proceeds were applied to our general working capital. On September 1, 2005, Unicom New World was merged into CUCL and legally dissolved upon the completion of such merger.

In September 2004, we completed the acquisition from Unicom Group of Unicom International, a limited liability company established in Hong Kong engaging in voice wholesale business, telephone cards business, line leasing services, managed bandwidth services and mobile virtual network services in Hong Kong and the United States. The total purchase price was HK\$37,465,996 (approximately RMB39.74 million including direct costs of acquisition), payable in cash.

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Under HKFRS, we have adopted the purchase method to account for our acquisitions from Unicom Group of Unicom New Century, which became effective on December 31, 2002, Unicom New World, which became effective on December 31, 2003, and Unicom International, which became effective in September 2004. Under the purchase method, in accordance with HKFRS, our consolidated financial statements incorporate the results of operations of Unicom New Century, Unicom New World and Unicom International only from the effective dates of the respective acquisitions. Accordingly, the results of operations of Unicom International for the period from the effective date of the acquisition to December 31, 2004 have been included in our consolidated statement of income for the year ended December 31, 2004. Our consolidated balance sheet as of December 31, 2004 includes the financial position of Unicom International. Since the effective date of the Unicom New World acquisition was December 31, 2003, our consolidated financial statements of income for the years ended December 31, 2003 and 2002 included in this annual report do not include the results of operations of Unicom New World. Our consolidated balance sheet as of December 31, 2003 includes the financial position of Unicom New World. Since the effective date of the Unicom New Century acquisition was December 31, 2002, our consolidated financial statements of income for the year ended December 31, 2002 do not include the results of operations of Unicom New Century. Our consolidated balance sheet as of December 31, 2002 includes the financial position of Unicom New Century. The differences between the cost of the acquisitions and the fair value of the identifiable assets and liabilities acquired was recognized as goodwill or negative goodwill, which were amortized on a straight line basis over its beneficial life or the remaining weighted average useful life of the acquired identifiable non-monetary assets. We ceased the amortization of goodwill from January 1, 2005 upon the adoption of HKFRS and the accumulated amortization as of December 31, 2004 has been eliminated with a corresponding decrease in the cost of goodwill. We also derecognized the negative goodwill previously recognized on or prior to January 1, 2005, with a corresponding adjustment to the opening balance of retained earnings. Starting from January 1, 2005, we no longer amortize goodwill but test it for impairment on an annual basis or when there is indication of impairment.

Under US GAAP, the acquisitions of Unicom New Century, Unicom New World and Unicom International are accounted for as a transfer of businesses under common control. Under this method, the acquired assets and liabilities are accounted for at their historical cost under US GAAP and the consolidated financial statements prepared under US GAAP for all periods presented are retroactively restated as if Unicom New Century, Unicom New World and Unicom International had always been part of our company since inception. This method is reflected in the significant differences between HKFRS and US GAAP provided in Note 37 to our consolidated financial statements.

Under HKFRS, the sale of Guoxin Paging by us to the Unicom Group, which became effective on December 31, 2003, has been accounted for as a sale of discontinued operation. The difference between the sale proceeds and the carrying amount of net assets of Guoxin Paging as of December 31, 2003 was recorded as the loss on sale of discontinued operation in our consolidated income statement for the year ended December 31, 2003. The operating results of Guoxin Paging from January 1, 2003 to the effective date of the sale of Guoxin Paging were included in our consolidated income statement for the year ended December 31, 2003.

Under US GAAP, the sale of Guoxin Paging to Unicom Group is considered a transfer of business between entities under common control and accounted for at historical cost of the net assets transferred, after reduction, if appropriate, for an indicated impairment of value. In addition, under US GAAP, the results of operations of a component or segment of an entity that has been disposed of should be reported in discontinued operations as a separate component of income, separately from continuing operations, in the period in which the disposal occurred and in prior periods. Accordingly, all the operating results of Guoxin Paging have been grouped into and reported in the income statement as Discontinued operation Loss from discontinued operation under US GAAP.

The acquisitions of Unicom New Century and Unicom New World and the sale of Guoxin Paging have had a material impact on our overall results of operations. In particular, our financial results in 2004 were significantly affected by the inclusion of the results of operations for Unicom New World we acquired effective December 31, 2003. By comparison, our financial results in 2003 did not include the results of operations of Unicom New World. See — Operating Results — Year Ended December 31, 2004 Compared to Year Ended December 31, 2003 below. These acquisitions have, among other things, significantly expanded the size of the telecommunications markets we serve and increased the number of our subscribers and usage of our services. As a result, our revenue and costs and expenses have also increased significantly.

#### ***Critical Accounting Policies***

The preparation of our financial statements and this annual report requires us to make estimates and judgment that affect the reported and disclosed amounts of assets and liabilities, including contingent assets and liabilities, as at the relevant dates and revenue and expenses for the relevant periods. We have identified the accounting policies and estimates below as critical to our business operations and an understanding of our results of operations and financial position. The impact and any associated risks related to these policies on our business operations are discussed throughout this Item 5 where such policies affect our reported and expected financial results. For a discussion of the application of these and other accounting policies, see Notes 2.2 and 4 to our consolidated financial statements included in this annual report. There can be no assurance that actual results will not differ from those estimates and assumptions.

#### **Capitalization of CDMA Customer Acquisition Costs**

We have been operating the CDMA business since the beginning of 2002. In order to accelerate the development of the CDMA business and subscriber growth, we began to offer certain promotional packages in the second half of 2002. As part of the contractual arrangements with certain CDMA contractual subscribers under these special promotional packages, CDMA handsets were provided to the subscribers for their use at no additional charge during the specified contract periods, which range from 6 months to 2 years. In return, the subscribers are required to incur a minimum amount of service fees during the contract period. If the contractual subscribers can fulfill the minimum contract spending amounts by the end of the contract period, they will not be obliged to repay the remaining costs of the CDMA handsets given for their use. In addition, to secure contract performance, these subscribers are required under their contracts to (i) prepay certain amounts of service fees or deposits, (ii) maintain a bank deposit in one of the designated commercial banks to secure their minimum contract amounts, or (iii) provide a guarantor who will compensate us for any loss in the event of the subscriber's non-performance of related contractual obligations.

We consider the costs of the CDMA handsets provided to contractual subscribers under these promotional packages as customer acquisition costs for the development of these new CDMA contractual subscribers. Such customer acquisition costs are capitalized to the extent reasonably expected to be recoverable, and amortized over the contractual periods (not exceeding two years), over which future economic benefits are expected to be received by us in the form of minimum contract revenue.

We determined the accounting policy for capitalization of customer acquisition costs of contractual CDMA subscribers after a careful evaluation of specific facts and circumstances, and believe that the capitalization of such costs is appropriate because future economic benefits are expected to be received by us in the form of future contractual revenues, taking into consideration (i) the historically high ARPUs and low churn, default or bad debt rates of these subscribers; (ii) our established procedures in and the relative low cost of enforcement of contracts in default; and (iii) the existence of specified contract periods with minimum contract spending amounts and built-in contractual safeguarding measures such as non-refundable prepayments, bank deposits, and guarantees received, as well as penalty clauses imposed on subscribers.



Therefore, we believe that the capitalized customer acquisition costs are recoverable from future revenue to be derived from these promotional packages, and the capitalization and amortization of these customer acquisition costs is an appropriate accounting policy. Furthermore, we continuously assess and evaluate the recoverability of these customer acquisition costs, based on detailed review of historical subscriber churn rates and estimated default rates. Based on our current assessment and evaluation, we believe that there is no significant problem in recovering the carrying amounts of the customer acquisition costs as of December 31, 2003, 2004 and 2005.

We have made the above recoverability assessments based on the current legal and operating environment relating to the subscribers' contract performance and other information currently available to us. Actual results may differ significantly from the current situation and our current estimates. If the situation changes significantly in the future, we may need to record additional non-recoverable customer acquisition costs based on conditions at that time.

#### **Recognition of Upfront Non-refundable Revenue and Direct Incremental Costs**

We capitalize and amortize upfront non-refundable revenue, including connection fees and activation fees of SIM cards or UIM cards from our GSM and CDMA cellular subscribers over expected customer service period. Accordingly, the related direct incremental costs of acquiring and activating GSM and CDMA subscribers, including costs of SIM or UIM cards and commissions which are directly associated with upfront non-refundable revenue received upon activation of cellular services, are also capitalized and amortized over the same expected customer service period. We only capitalize costs where we consider that they will generate future economic benefits. The excess of the direct incremental costs over the corresponding upfront non-refundable revenue, if any, are expensed off to the statement of income immediately.

The expected customer service period for our cellular business is estimated based on the expected stabilized churn rates of subscribers after taking into consideration factors such as our customer retention experience, the expected level of competition, the risk of technological or functional obsolescence of our services and the current regulatory environment. If our estimate of the expected stabilized churn rate changes for future periods as a result of unexpected changes in competition environment, telecommunication technology or regulatory environment, the amount and timing of recognition of these direct incremental costs and our deferred revenue would also change.

#### **Lease of CDMA Network Capacity**

- (i) Original CDMA lease agreements

We had entered into a CDMA network capacity lease agreement with Unicom Group and its wholly-owned subsidiary, Unicom New Horizon, in December 2001. Pursuant to this CDMA lease agreement, Unicom New Horizon agreed to lease the capacity of the CDMA network to us covering the nine provinces of Guangdong, Jiangsu, Zhejiang, Fujian, Liaoning, Shandong, Anhui, Hebei, Hubei and the three municipalities of Beijing, Shanghai and Tianjin. This lease became effective on January 8, 2002.

In addition, on December 31, 2002 and 2003, we acquired all the equity interests in Unicom New Century and Unicom New World, respectively, which together operate GSM and CDMA cellular businesses in another 12 provinces, one municipality and five autonomous regions in the PRC. Unicom New Century and Unicom New World had also respectively entered into a CDMA lease agreement with Unicom Group and Unicom New Horizon on similar terms and conditions. These lease agreements and the lease agreement entered in 2001 are collectively referred to as the Old CDMA Leases.

According to the terms of the Original CDMA Leases, the initial lease period is one year, renewable for additional one-year terms at our own option. We have the exclusive right to lease and operate the CDMA network capacity in the above regions. Also, we have the option to add or reduce the capacity leased by giving advance notice. The lease fee per unit of capacity is calculated on the basis that if full capacity is leased, it would permit Unicom New Horizon to recover its investment in constructing the CDMA network in seven years, with an internal return of 8%. In January 2004, we renewed the CDMA network capacity for an additional one-year term. We had the option to purchase the network assets based on the appraised value of the network determined by an independent appraiser.

We assessed the appropriate lease classification at the inception of the Old CDMA Leases. Factors and related implications we have considered include whether we have taken the risks and rewards of ownership of the CDMA assets. Furthermore, we have considered whether the existence of the purchase option and the annual renewal option, combined with the related economic penalties, risks and benefits, have caused us to take on risks and rewards similar to those that an owner of these assets would bear.

Unicom New Horizon has the legal ownership of the CDMA network, is directly responsible for the planning, financing and construction of the CDMA network, and directly enters into all contracts with suppliers and constructors. We believe we only bear the risks associated with the operation of the CDMA business during the relevant leasing periods and are free from any ownership risks of the CDMA network. According to the terms of the Old CDMA Leases, the initial lease period was only one year, with renewal of additional one-year terms at our option. Accordingly, there was no pre-determined lease period and minimum network capacity to be leased in future periods. We had the option to determine whether we would renew and continue the leases and how much capacity to lease. We also had the option to decide whether we would exercise the purchase option of CDMA network based on then market conditions and future operating performance of the CDMA business, subject to approvals obtained from our independent minority shareholders.

Accordingly, if the CDMA business turns out to be unsuccessful, we did not have the obligation under the Old CDMA Leases to continue this CDMA lease arrangement or to exercise the purchase option.

In general, the classification of leases is dependent on whether the risks and rewards of ownership of the leased assets rest substantially with the lessor or the lessee. Leases that substantially transfer to the lessee all the risks and rewards of ownership of the leased assets are accounted for as finance leases; and leases where substantially all the risks and rewards of ownership of the leased assets remain with the lessor are accounted for as operating leases. When performing this assessment, we have considered a number of factors as stated above that required significant judgment.

At the inception of the Old CDMA Leases, there was a high degree of uncertainty related to the market condition and operating results of the CDMA business. It was highly uncertain whether we would continue to lease the network in the future or to estimate the future network capacity to be leased. We were also unable to determine whether or not we would exercise the purchase option. Given these uncertainties and due to the fact that the risks associated with the ownership of the CDMA assets substantially remained with Unicom Group and Unicom New Horizon, we accounted for the leasing of the CDMA network as operating leases for the initial lease periods, estimated to be three years, so as to reflect the respective rights and obligations of the relevant parties to the Old CDMA Leases.

(ii) New CDMA lease agreement

On March 24, 2005, we have entered into the New CDMA Lease with Unicom Group and Unicom New Horizon to replace the Old CDMA Leases. The New CDMA Lease was approved by our minority shareholders on May 12, 2005 and became retroactively effective from January 1, 2005. Key terms of the New CDMA Lease, including exclusive operating rights and purchase option, are substantially similar to those contained in the Old CDMA Leases except that (i) the initial lease period is two years, with full CDMA constructed network capacity to be leased from Unicom New Horizon, and (ii) the annual lease fee shall be determined based on the audited annual service revenue of our CDMA cellular business. For more detailed discussions of the terms of the New CDMA Lease, see B. Related Party Transactions- Leasing of CDMA Network Capacity New CDMA Lease under Item 7.

Under the New CDMA Lease, we believe the CDMA business continue to involve a significant level of uncertainties, particularly due to the fact that (i) the CDMA business still recorded a loss in 2005; (ii) the uncertainty of the future success of CDMA business arising from intense market competition; and (iii) the uncertainty in the future changes in technology standards and government regulatory environment in relation to 3G services. At the inception of the New CDMA Lease, we were unable to determine whether we would renew the lease after the initial two-year lease term or whether we would exercise the purchase option. Given these uncertainties, we consider the risks associated with the ownership of the CDMA assets still substantially remain with Unicom Group and Unicom New Horizon, and have concluded that the New CDMA Lease should be classified as an operating lease.

At the end of the current lease term, we will reassess the appropriate classification based on the relevant factors and circumstances available at that time. Based on the above accounting judgment we made, the operating lease expense has been recorded in the statements of income since the commencement of the Old CDMA Leases and the New CDMA Lease, and the carrying value of the CDMA assets and the related liabilities have not been reflected in the balance sheets. For the year ended December 31, 2005, we recorded lease expense of approximately RMB7.92 billion under the New CDMA Lease.

**Depreciation of Property, Plant and Equipment**

Depreciation of our property, plant and equipment is calculated using the straight-line method to allocate cost or revalued amounts to residual values over the estimated useful lives. We review the useful lives and residual values periodically to ensure that the method and rates of depreciation are consistent with the expected pattern of realization of economic benefits from property, plant and equipment. We use estimates of useful lives of property, plant and equipment based on historical experience, taking into account anticipated technological changes. If there are significant changes from previously estimated useful lives, the amount of depreciation expense may be adjusted. The cost and accumulated depreciation of property, plant and equipment as of December 31, 2005 amounted to RMB190.9 billion and RMB74.8 billion, respectively, as compared to RMB173.8 billion and RMB55.3 billion, respectively, as of December 31, 2004.

**Impairment of Non-current Assets**

At each balance sheet date, we perform a review of internal and external sources of information to identify indications that our non-current assets, including property, plant and equipment and goodwill, may be impaired. In addition, we review (i) our assets that have indefinite useful life that are not subject to amortization and (ii) our assets that are subject to depreciation or amortization for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. We continually monitor our businesses, markets and business environment and make judgments and assessment as to whether any impairment event or change has occurred. An impairment loss is recognized whenever the carrying amount of an asset exceeds its recoverable amount. The recoverable amount is the higher of (i) an asset's fair value less costs to sell and (ii) value-in-use. We estimate value-in-use based on estimated discounted future cash flows of a cash-generating asset unit, which is the smallest group of assets that generates cash flows independently.

In making judgment on the recoverability of non-current assets, we need to assess whether: (i) an event has occurred that may affect an asset's value; (ii) the carrying value of an asset can be supported by the discounted future cash flows from such asset and (iii) the cash flow is discounted at an appropriate rate. Changes in any of these assessments could result in significant changes to our estimates of the recoverability of our non-current assets.

#### **Provision for Doubtful Debts**

Accounts receivables are stated at cost, less provision for doubtful debts. We evaluate specific accounts receivable where there are indications that the receivable may be doubtful or is not collectible. We record a provision based on our best estimates to reduce the receivable balance to the amount that is expected to be collected. For the remaining receivable balances as of each period-end, we make a provision based on observable data indicating that there is a measurable decrease in the estimated future cash flows from the remaining receivable balances. We make such estimates based on our past experience, historical collection patterns, subscribers' credit worthiness and collection trends. For the general subscribers of cellular, long distance, data and Internet services, we make a full provision for receivables aged over 3 months, which is consistent with our credit policy with respect to relevant subscribers.

Our estimates described above are based on our historical experience, subscriber creditworthiness and collection trends. If circumstances change (e.g. due to factors including developments in our business and the external market environment), we may need to re-evaluate our policies on doubtful debts, and make additional provisions in the future.

#### **Provision for Subscriber Reward Program**

Since 2004, we have implemented a subscriber reward program, which is a bonus point-based scheme that rewards subscribers according to their service consumption, loyalty and payment history. The estimated liability is recognized based on (i) the value of each bonus point awarded to subscribers, (ii) the number of bonus points relating to subscribers who are qualified to exercise their redemption right at the end of a period and (iii) the estimated number of bonus points relating to subscribers who have no right to redeem the incentives at the end of a period, but who are expected to ultimately earn and claim awards under the reward program. When subscribers redeem rewards or their entitlements expire, the provision will be adjusted accordingly. We have recognized the liability amounting to RMB337 million as of December 31, 2005, as compared to RMB40 million as of December 31, 2004. As we have limited historical data in respect of the redemption of bonus points, we may need to re-assess our accruing method for the potential bonus point liability when we obtain a more reliable historical redemption rate in future.

#### **Income Tax and Deferred Taxation**

Income tax is provided based on income before tax for statutory financial reporting purposes, adjusted for income and expense items that are not assessable or deductible for tax purposes and taking into consideration any preferential tax treatment to which we are entitled.

Deferred taxation is provided in full, using the liability method, on temporary differences arising between the tax basis of assets and liabilities and their carrying amounts in the financial statements. Deferred tax assets are recognized to the extent that it is probable that future taxable income will be available against which the temporary differences can be utilized.

In the preparation of our financial statements, we estimate our income tax provision and deferred taxation in accordance with the prevailing tax rules and regulations, taking into account any special approvals obtained from relevant tax authorities and any preferential tax treatment to which we are entitled in each location or jurisdiction in which we operate. This process involves estimation made by us about our current tax exposure together with an assessment of temporary differences resulting from different treatment of items for tax and accounting purposes in order to determine the amount of tax provisions for the period. We believe that we have recorded adequate tax provisions based on our best estimates and assumptions. For the evaluation of temporary differences, we have assessed the likelihood that the deferred taxes could be recovered. Major deferred tax components relate to interest on loans from China-China-Foreign ( CCF ) joint ventures, loss arising from terminations of CCF arrangements, provisions for doubtful debts, deferral and amortization of upfront non-refundable revenue, capitalization and amortization of direct incremental cost, capitalized interest already deducted for tax purposes and accruals of expenses not yet deductible for tax purposes. Due to the effects of these temporary differences on income tax, we have recorded deferred tax assets amounting to RMB335 million and RMB469 million as of December 31, 2005 and 2004, respectively. Deferred tax assets are recognized based on our estimates and assumptions that they will be recovered from taxable income arising from the continuing operations in the foreseeable future.

We believe we have recorded adequate current and deferred taxes based on prevailing tax rules and regulations and our current best estimates and assumptions. In the event that future tax rules and regulations or related circumstances change, adjustments to current and deferred taxes may be necessary.

### ***Operating Results***

#### **Year Ended December 31, 2005 Compared to Year Ended December 31, 2004**

In 2005, our revenue continued to increase, by 10.1% from RMB79.09 billion in 2004 to RMB87.05 billion in 2005. This growth was principally due to the relatively rapid growth of our CDMA cellular business and steady growth of our GSM cellular business. For the reasons discussed below, our cellular businesses continued to increase in terms of revenues and in their percentage contribution to our overall business, while our long distance, data and Internet businesses continued to decrease in terms of revenues and in their contribution to our business.

Due to factors discussed below, in 2005 our costs and expenses grew 10.1%, the same rate as that of our revenue. As a result, while our income before income tax increased by 9.8% to RMB7.10 billion, our income before income tax margin stood at 8.2%, the same as that of 2004. Segment income before income tax margin in our GSM cellular business decreased from 14.3% in 2004 to 14.0% in 2005. Our CDMA cellular business maintained relatively rapid growth in 2005 and its loss before income tax decreased by 64.5%. In our long distance and data and Internet businesses, segment income before income tax decreased 66.8% in 2005 and segment income before income tax margin decreased to 1.7% in 2005 from 4.8% in 2004.

Our net income in 2005 increased by 9.7% to RMB4.93 billion, for reasons discussed below.

## Revenue

Revenue from our GSM cellular business grew steadily in 2005 and continued to generate a majority of our total revenue, while revenue from our CDMA cellular business maintained its growth in 2005 and further increased its share of our total revenue for the year. Revenues from our GSM and CDMA cellular businesses represented 94.7% of our total revenue in 2005, as compared with 93.0% in 2004. The share of revenue from the CDMA cellular business in our total revenue increased from 32.9% in 2004 to 34.8% in 2005, while the share of revenue from the GSM cellular business in our total revenue slightly decreased from 60.1% in 2004 to 59.9% in 2005. Revenues from our long distance and data and Internet businesses decreased from RMB5,528 million in 2004 to RMB4,590 million in 2005. Aggregate revenues from our long distance business and our data and Internet businesses represented 5.3% of our total revenue in 2005, as compared with 7.0% in 2004. We believe the changes in our revenue composition reflect our focus on the development of our cellular businesses.

## Cellular Revenue

For the reasons discussed below, revenues from our GSM and CDMA cellular businesses (including revenues from sales of telecommunications products) together increased by 12.1%, from RMB73.56 billion in 2004 to RMB82.46 billion in 2005.

*GSM Cellular Business.* Revenue from our GSM cellular business increased by 9.7%, from RMB47.51 billion in 2004 to RMB52.14 billion in 2005, primarily due to the continued increases in the total number of our total GSM cellular subscribers and in our subscribers' average MOU. The total number of our GSM cellular subscribers increased by 12.8%, from 84.27 million as of December 31, 2004 to 95.07 million as of December 31, 2005. With the continually increasing cellular penetration in China, an increasing proportion of new subscribers are relatively low-end subscribers. As a result, ARPU from the GSM cellular business declined 1.8%, from RMB49.4 in 2004 to RMB48.5 in 2005. The average MOU per subscriber per month increased 7.0%, from 188.9 minutes in 2004 to 202.2 minutes in 2005.

The table below sets forth the revenue composition of our GSM cellular business and each revenue item's respective share of total GSM revenue in the years ended December 31, 2003, 2004 and 2005.

|                                      | 2003 (Restated) |                        | 2004 (Restated) |                        | 2005           |                        |   |
|--------------------------------------|-----------------|------------------------|-----------------|------------------------|----------------|------------------------|---|
|                                      | RMB in million  | As percentage of total | RMB in million  | As percentage of total | RMB in million | As percentage of total |   |
| Revenue                              | 41,201          | 100.0                  | 47,513          | 100.0                  | 52,139         | 100.0                  | % |
| Service Revenue                      | 41,153          | 99.9                   | 47,509          | 100.0                  | 52,136         | 100.0                  | % |
| Usage Fee                            | 29,072          | 70.6                   | 31,997          | 67.3                   | 32,077         | 61.5                   | % |
| Monthly Fee                          | 7,042           | 17.1                   | 6,922           | 14.6                   | 6,841          | 13.1                   | % |
| Interconnection                      |                 |                        |                 |                        |                |                        |   |
| Revenue                              | 1,927           | 4.7                    | 2,614           | 5.5                    | 3,466          | 6.6                    | % |
| Others                               | 3,112           | 7.5                    | 5,976           | 12.6                   | 9,752          | 18.8                   | % |
| Sales of Telecommunications Products | 48              | 0.1                    | 4               | 0.0                    | 3              | 0.0                    | % |

The growth in total usage of our GSM cellular services has been largely offset by the decrease in the ARPU. As a result, usage fees for GSM cellular services only increased by 0.3% from RMB32.00 billion in 2004 to RMB32.08 billion in 2005, representing 61.5% of total GSM service revenue, a decrease from 67.3% in 2004. Monthly fees decreased by 1.2%, from RMB6.92 billion in 2004 to RMB6.84 billion in 2005, and represented 13.1% of total GSM service revenue as compared with 14.6% in 2004. This decrease is primarily due to an increasing number of package service plans no longer charging monthly fee separately. Interconnection revenue increased by 32.6% from RMB2.61 billion in 2004 to RMB3.47 billion in 2005, and represented 6.6% of total service revenue as compared with 5.5% in 2004. This increase is primarily due to the increased total usage of our GSM cellular services.

While continuing to meet the diverse needs of our customers in the mass market, our GSM cellular business aims to actively promote value-added services. As a result, revenue from value-added services significantly increased its contribution to our total GSM cellular revenue. Revenue from our GSM value-added cellular services increased 62.8%, from RMB4.86 billion in 2004 to RMB7.91 billion in 2005. Its share of total GSM service revenue increased from 10.2% in 2004 to 15.2% in 2005. Of the total revenue from GSM value-added cellular services, revenue from short messaging services increased 28.3% from RMB2.79 billion in 2004 to RMB3.71 billion in 2005, and its share of total GSM service revenue grew from 6.1% in 2004 to 7.1% in 2005.

*CDMA Cellular Business.* Our CDMA subscriber base has continued to expand at a relatively fast pace. In 2005, the growth in our CDMA subscriber base resulted in increased revenue from the CDMA cellular business. Revenue from our CDMA cellular business reached RMB30.32 billion in 2005, a 16.4% increase over RMB26.05 billion in 2004. This increase was primarily due to a 17.6% increase in our CDMA subscribers.

The table below sets forth the revenue composition of our CDMA cellular business and each revenue item's respective share of total CDMA revenue for the years ended December 31, 2003, 2004 and 2005.

|                                      | 2003 (Restated) |                        | 2004 (Restated) |                        | 2005           |                        |   |
|--------------------------------------|-----------------|------------------------|-----------------|------------------------|----------------|------------------------|---|
|                                      | RMB in million  | As percentage of total | RMB in million  | As percentage of total | RMB in million | As percentage of total |   |
| Revenue                              | 18,063          | 100.0                  | 26,046          | 100.0                  | 30,320         | 100.0                  | % |
| Service Revenue                      | 16,667          | 92.3                   | 24,378          | 93.6                   | 27,577         | 91.0                   | % |
| Usage Fee                            | 11,672          | 64.6                   | 16,165          | 62.1                   | 16,727         | 55.2                   | % |
| Monthly Fee                          | 3,488           | 19.3                   | 4,638           | 17.8                   | 4,905          | 16.2                   | % |
| Interconnection Revenue              | 608             | 3.4                    | 927             | 3.6                    | 1,399          | 4.6                    | % |
| Others                               | 899             | 5.0                    | 2,648           | 10.1                   | 4,546          | 15.0                   | % |
| Sales of Telecommunications Products | 1,396           | 7.7                    | 1,668           | 6.4                    | 2,743          | 9.0                    | % |

CDMA usage fees increased by 3.5% from RMB16.17 billion in 2004 to RMB16.73 billion in 2005, and represented 55.2% of total CDMA service revenue as compared with 62.1% in 2004. The decrease in the percentage of total CDMA service revenue was primarily due to the rapid increase in revenue from value-added CDMA services. With the expansion of our CDMA 1X wireless data services in 2005, we have been actively developing our CDMA wireless data business, by making efforts to leverage the competitive edge of the CDMA technology. Revenue from CDMA value-added cellular services reached RMB4.05 billion in 2005, an increase of 70.2% from RMB2.38 billion in 2004, and accounted for 14.7% of total service revenue from the CDMA cellular business in 2005. Of the total revenue from CDMA value-added cellular services, revenue from CDMA 1X wireless data services increased 92.1% from RMB0.68 billion in 2004 to RMB1.31 billion in 2005, and its share of total CDMA service revenue grew from 2.8% in 2004 to 4.8% in 2005. We expect revenue from value-added CDMA services will continue to grow significantly, as we will continue to focus on the development and marketing of such value-added services.





Monthly fees increased by 5.8%, from RMB4.64 billion in 2004 to RMB4.91 billion in 2005, and represented 17.8% of total CDMA service revenue as compared with 19.0% in 2004. Interconnection revenue increased by 50.9% from RMB0.93 billion in 2004 to RMB1.40 billion in 2005, and represented 5.1% of total service revenue as compared with 3.8% in 2004. This increase is primarily due to the increased usage of our CDMA cellular services.

***Long Distance and Data and Internet Revenue***

*Long Distance Business.* Revenue from our domestic and international long distance business decreased by 17.2%, from RMB1.85 billion in 2004 to RMB1.53 billion in 2005. Such decrease is primarily due to the decrease in tariffs as a result of intensified competition.

*Data and Internet Business.* Revenue from our data and Internet businesses decreased by 16.9% from RMB3.68 billion in 2004 to RMB3.06 billion in 2005 primarily due to the decrease in tariffs as a result of intensified competition.

As a result of the foregoing, revenues from our long distance and data and Internet businesses were RMB4.59 billion, a decrease of 17.0% from 2004.

***Costs and expenses***

Costs and expenses in 2005 were RMB79.95 billion, representing an increase of 10.1% over 2004, same as the 10.1% growth in revenue for the same period. Certain items of costs and expenses, however, had a higher rate of increase, such as the 18.2% increase in leased lines and network capacities expenses, the 11.4% increase in interconnection charges and the 21.7% increase in employee benefit expenses. Due to the expansion of our CDMA business, leased lines and network capacities expenses (which include the expenses from the CDMA network leases) increased faster than our revenue in 2005. As our various business segments continued to develop, interconnection charges also increased faster than our revenue in 2005 since the interconnection rates remain unchanged while our effective tariffs have been declining due to continued price competition in 2005. Our employee benefit expenses also grew faster than our revenue in 2005 due to factors including a general increase in employee insurance and social security expenses.

In 2005, we effectively implemented the business strategy of effective growth, i.e., profit driven growth, by focusing on cost control and optimization of our expense structure in order to ensure continued growth in earnings. Our costs and expenses as a percentage of total revenue stood at 91.8% in 2005, the same as that in 2004.

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The table below illustrates the major expense items from 2003, 2004 and 2005 and their respective shares of total revenue.

|  | For the year ended December 31, |                    |   |                 |                    |   |                |                    |   |
|--|---------------------------------|--------------------|---|-----------------|--------------------|---|----------------|--------------------|---|
|  | 2003 (Restated)                 |                    |   | 2004 (Restated) |                    |   | 2005           |                    |   |
|  | RMB in million                  | % of Total Revenue |   | RMB in million  | % of Total Revenue |   | RMB in million | % of Total Revenue |   |
| Costs and expenses   | 60,956                          | 90.8               | % | 72,616          | 91.8               | % | 79,947         | 91.8               | % |
| Leased lines and network capacities                                  | 4,320                           | 6.4                | % | 7,398           | 9.4                | % | 8,748          | 10.0               | % |
| Interconnection charges  | 5,921                           | 8.8                | % | 7,517           | 9.5                | % | 8,372          | 9.6                | % |
| Depreciation and amortization  | 16,359                          | 24.4               | % | 19,011          | 24.0               | % | 20,368         | 23.4               | % |
| Employee benefit expenses  | 4,596                           | 6.8                | % | 4,615           | 5.8                | % | 5,616          | 6.5                | % |
| Selling and marketing  | 15,264                          | 22.7               | % | 19,523          | 24.7               | % | 20,558         | 23.6               | % |
| General, administrative and other expenses                           | 9,139                           | 13.7               | % | 10,500          | 13.3               | % | 11,742         | 13.5               | % |
| Include: Impairment loss and assets write-off of the Paging Business | 557                             | 0.8                | % |                 | 0.0                | % |                | 0.0                | % |
| Cost of telecommunications products sold                             | 2,939                           | 4.4                | % | 2,563           | 3.2                | % | 3,575          | 4.1                | % |
| Loss on sale of discontinued operation (Guoxin Paging)               | 663                             | 1.0                | % |                 | 0.0                | % |                | 0.0                | % |
| Finance costs  | 1,946                           | 2.9                | % | 1,696           | 2.1                | % | 1,099          | 1.2                | % |
| Interest income  | -173                            | -0.3               | % | -103            | -0.1               | % | -96            | -0.1               | % |
| Other gains, net   | -18                             | 0.0                | % | -104            | -0.1               | % | -35            | 0.0                | % |

*Leased Lines and Network Capacities.* With the increase in our CDMA subscribers, the lease expense for CDMA network capacities increased by 20.3%, from RMB6.59 billion in 2004 to RMB7.92 billion in 2005. Leased lines and network capacities expenses as a percentage of total revenue rose slightly from 9.4% in 2004 to 10.0% in 2005.

*Interconnection Charges.* Interconnection charges reached RMB8.37 billion in 2005, representing an increase of 11.3% from 2004, primarily due to the increase in interconnection traffic volume as a result of the development of our GSM and CDMA cellular business and long distance, data and Internet businesses. As our various business segments continued to develop, interconnection charges as a percentage of total revenue also slightly increased from 9.5% in 2004 to 9.6% in 2005.

*Depreciation and Amortization.* Depreciation and amortization expenses increased by 7.2% to RMB20.37 billion in 2005, a lower growth rate than the growth rate in revenue. The increase in depreciation and amortization expenses resulted from expanded network capacity and the expansion of assets scale, which was partly offset by our cessation of the amortization of goodwill in 2005 in accordance with the changed accounting policies described above. Depreciation and amortization expenses as a percentage of total revenue decreased slightly from 24.0% in 2004 to 23.4% in 2005.

*Employee Benefit Expenses.* As of the end of 2005, we had 53,070 employees, an increase of 34.1% from 39,589 at the end of 2004. Our employee benefit expenses increased from RMB4.62 billion in 2004 to RMB5.62 billion in 2005. Its share as a percentage of total revenue increased from 5.8% in 2004 to 6.5% in 2005. The increase in employee benefit expenses in 2005 was mainly due to the following factors: (i) a general increase in mandatory employee insurance and social security expenses; (ii) the adoption of HKFRS which required the share-based payments arising from the share options to be amortized over the vesting period and recorded as employee benefit expenses and (iii) the conversion of a significant number of previously contracted workers to our formal employees.



*Selling and Marketing.* Our major selling and marketing expenses included commissions, promotion and advertising expenses, amortization of customer acquisition costs of contractual CDMA subscribers and customer retention costs. Due to our effective cost control measures, selling and marketing expenses totaled RMB20.56 billion in 2005, an increase of 5.3% from 2004, significantly lower than the growth rate of the total revenue in 2005. Amortization of contractual CDMA subscribers acquisition costs in 2005 were RMB5.95 billion, a decrease of 2.8% from 2004. The balance of unamortized deferred CDMA subscriber acquisition costs significantly decreased from RMB4.74 billion as of the end of 2004 to RMB2.94 billion as of the end of 2005 primarily due to our efforts in reducing the use of CDMA handset promotional packages. Due to the continued growth in the subscriber base of our various business segments, the commissions to distributors and sales agents rose to RMB8.89 billion, an increase of 7.5%. Promotion and advertising expenses were RMB2.53 billion, an increase of 6.3%. Selling and marketing expenses as a percentage of revenue decreased from 24.7% in 2004 to 23.6% in 2005.

*General, Administrative and Other Expenses.* As a result of our increased network maintenance costs due to the expiration of many equipment warranties, our general, administrative and other expenses were RMB11.74 billion in 2005, representing an increase of 11.8% from RMB10.50 billion in 2004. General, administrative and other expenses as a percentage of total revenue increased slightly from 13.3% in 2004 to 13.5% in 2005. In 2005, as a result of our credit control measures, the provision for doubtful debts fell to RMB1.50 billion, a significant decrease of 31.6% from 2004. Provision for doubtful debts as a percentage of service revenue decreased from 2.8% in 2004 to 1.7% in 2005.

*Cost of Telecommunications Products Sold.* The cost of telecommunication products sold increased by 39.5% from RMB2.56 billion in 2004 to RMB3.58 billion in 2005. This increase was primarily due to a significant increase in CDMA handset units purchased from manufacturers and sold to customers during 2005 as compared to 2004. The share of cost of telecommunications products sold as a percentage of revenue increased from 3.2% in 2004 to 4.1% in 2005.

*Interest Income and Finance Costs.* Our interest income was RMB0.10 billion in 2005, the same as in 2004. Our finance costs decreased from RMB1.70 billion in 2004 to RMB1.10 billion in 2005, primarily due to the increased portion of short-term borrowings in our indebtedness. In addition, we recorded a foreign exchange gain of RMB0.20 billion due to the revaluation of Renminbi against U.S. dollars, which significantly contributed to the decrease of our finance costs. The above factors resulted in net finance costs of RMB1.00 billion in 2005, a decrease of 37.0% from the net finance costs of RMB1.59 billion in 2004.

#### ***Segment income (loss) before income tax***

In 2005, our revenue and our costs and expenses both increased by 10.1%. While our income before income tax reached RMB7.10 billion, an increase of 9.8% from 2004, our income before taxation margin was 8.2% in both 2005 and 2004.

*GSM Cellular Business.* In our GSM cellular business, segment income before income tax was RMB7.28 billion in 2005, an increase of 6.5% from 2004. The increase in the segment income before income tax of our GSM cellular business mainly reflects the 7% increase in the average monthly MOU per subscriber which was partially offset by the 1.8% decline in the ARPU for our GSM cellular business. Our segment income before taxation margin in the GSM cellular business slightly decreased from 14.3% in 2004 to 14.0% in 2005.

*CDMA Cellular Business.* We incurred a segment loss before income tax of RMB0.2 billion in 2005 for our CDMA business, a 64.5% decrease from the segment loss before income tax of RMB0.56 billion in 2004. The decrease of segment loss before income tax of our CDMA cellular business was primarily due to the continued expansion of CDMA cellular business subscriber base, the rapid growth of CDMA value-added services and the effective control of sales and marketing costs, partially offset by the decrease in CDMA cellular subscribers' average MOU per month and the ARPU.

*Long Distance Business.* In our long distance business, segment income before income tax decreased 62.8%, from RMB0.50 billion in 2004 to RMB0.18 billion in 2005, primarily due to reduced tariff level as a result of increased competition. As a result, the segment income before taxation margin in our long distance business decreased from 15.9% in 2004 to 6.8% in 2005.

*Data and Internet Business.* In our data and Internet businesses, we had a segment loss before income tax of RMB0.04 billion in 2005, compared with the segment loss before income tax of RMB0.07 billion in 2004.

#### ***Net Income***

*Income Tax.* As a result of our increased income before income tax, our income tax increased to RMB2.17 billion in 2005, an increase of 9.8% from 2004. Our effective tax rates in 2004 and 2005 were both 30.6%.

*Net Income.* As a result of the foregoing, our net income was RMB4.93 billion in 2005, representing an increase of 9.7% from 2004. Net income per share increased 8.3%, from RMB0.36 in 2004 to RMB0.39 in 2005.

#### ***Impact of Differences between HKFRS and US GAAP***

In addition to the above management discussion and analysis of our results of the operation under HKFRS between the years ended December 31, 2005 and 2004, in connection with the preparation and reconciliation of our consolidated financial statements in accordance with US GAAP, we believe there are no material differences between HKFRS and US GAAP that would have a significant impact on the discussion and analysis of our results of operations between the years ended December 31, 2005 and 2004. Our combined revenue under US GAAP increased from RMB79.39 billion in 2004, to RMB87.25 billion in 2005, representing an increase of 9.9%. Our net income under US GAAP increased from RMB4.71 billion in 2004 to RMB5.01 billion in 2005, representing an increase of 6.4%. See also Note 37 to the consolidated financial statements for a more detailed summary of all significant accounting differences between HKFRS and US GAAP that are relevant to us.

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

Our results of operations in 2004 were materially affected by our acquisitions of Unicom New World effective December 31, 2003. In particular, our revenue and costs and expenses increased significantly in 2004, which was primarily due to the inclusion of the results of operations of Unicom New World. By comparison, our results in 2003 did not include the results of operations of Unicom New World. As a result, our results of operations in 2004 are not directly comparable with those in prior years. See – Acquisitions of Unicom New Century, Unicom New World and Unicom International and Sale of Guoxin Paging above. See also A. The History and Development of the Company Acquisitions of Unicom New Century and Unicom New World and Sale of Guoxin Paging under Item 4 above.

In 2004, our revenue continued to increase, by 17.8% from RMB67.15 billion in 2003 to RMB79.09 billion in 2004. This growth was principally due to the strong growth of our CDMA cellular business and continued growth of our GSM cellular business, as well as the inclusion of revenue attributable to Unicom New World, which we acquired effective December 31, 2003. Our cellular businesses continued to increase in their percentage contribution to our overall business. Our long distance, data and Internet businesses decreased in terms of revenues and in their contribution to our business.

Due to factors discussed below, in 2004 our costs and expenses grew 19.1%. As a result, our income before income tax increased by 4.4% to RMB6.47 billion, while our income before income tax margin decreased to 8.2%, as compared with 9.2% in 2003. Segment income before taxation margin in our GSM cellular business decreased from 17.3% in 2003 to 14.3% in 2004. In our long distance and data and Internet businesses, segment income before income tax decreased 68.0% in 2004 and segment income before taxation margin decreased to 4.8% in 2004 from 15.8% in 2003.

Our net income in 2004 increased by 5.3% to RMB4.49 billion, for reasons discussed below.

### **Revenue**

Revenue from our GSM cellular business grew steadily in 2004 and continued to generate a majority of our total revenue, while revenue from our CDMA cellular business sustained fast growth in 2004, significantly increasing its share of our total revenue for the year. Our CDMA cellular business, introduced in January 2002, generated RMB26.05 billion in revenue in 2004, contributing 66.9% of our total revenue growth in that year. Revenues from our GSM and CDMA cellular businesses represented 93.0% of our total revenue in 2004, as compared with 88.3% in 2003. The share of revenue from the CDMA cellular business in our total revenue increased from 26.9% in 2003 to 32.9% in 2004, while the share of revenue from the GSM cellular business in our total revenue decreased from 61.4% in 2003 to 60.1% in 2004. Revenues from our long distance and data and Internet businesses slightly decreased from RMB5,733 million in 2003 to RMB5,528 million in 2004. Revenues from our long distance business and our data and Internet businesses represented 2.3% and 4.6 %, respectively, of our total revenue in 2004, as compared with 3.4% and 5.1%, respectively, in 2003. The growth in our total revenue, however, was partially offset by the sale of our paging business, effective December 31, 2003. We believe the changes in our revenue composition reflect our focus on the development of our cellular businesses.

### **Cellular Revenue**

For the reasons discussed below, revenues from our GSM and CDMA cellular businesses (including revenues from sales of telecommunications products) together increased by 24.1%, from RMB59.26 billion in 2003 to RMB73.56 billion in 2004.

*GSM Cellular Business* Revenue from our GSM cellular business increased by 15.3%, from RMB41.20 billion in 2003 to RMB47.51 billion in 2004, primarily due to the continued increase in the total number of our total GSM cellular subscribers as a result of organic subscriber growth and the effect of our acquisition of Unicom New World. The total number of our GSM cellular subscribers increased by 31.8%, from 63.92 million as of December 31, 2003 to 84.27 million as of December 31, 2004. As a result of continuing cellular penetration expansion, an increase in the proportion of low-usage subscribers among new subscribers, an increased number of pre-paid subscribers, and increasing market competition negatively affecting effective pricing, ARPU from the GSM cellular business declined 12.9%, from RMB56.7 in 2003 to RMB49.4 in 2004.

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The table below sets forth the revenue composition of our GSM cellular business and each revenue item's respective share of total GSM revenue in the years ended December 31, 2002, 2003 and 2004.

|                                      | 2002 (Restated) |                        | 2003 (Restated) |                        | 2004 (Restated) |                        |   |
|--------------------------------------|-----------------|------------------------|-----------------|------------------------|-----------------|------------------------|---|
|                                      | RMB in million  | As percentage of total | RMB in million  | As percentage of total | RMB in million  | As percentage of total |   |
| Revenue                              | 27,927          | 100.0                  | % 41,201        | 100.0                  | % 47,513        | 100.0                  | % |
| Service Revenue                      | 27,890          | 99.9                   | % 41,153        | 99.9                   | % 47,509        | 100.0                  | % |
| Usage Fee                            | 20,275          | 72.6                   | % 29,072        | 70.6                   | % 31,997        | 67.3                   | % |
| Monthly Fee                          | 4,169           | 14.9                   | % 7,042         | 17.1                   | % 6,922         | 14.6                   | % |
| Interconnection Revenue              | 1,710           | 6.1                    | % 1,927         | 4.7                    | % 2,614         | 5.5                    | % |
| Others                               | 1,736           | 6.3                    | % 3,112         | 7.5                    | % 5,976         | 12.6                   | % |
| Sales of Telecommunications Products | 37              | 0.1                    | % 48            | 0.1                    | % 4             | 0.0                    | % |

Due to the growth in total usage of our GSM cellular services (including the effects of our acquisition of Unicom New World) and the increasing proportion of pre-paid cellular subscribers (who do not pay monthly fees), usage fees for GSM cellular services increased by 10.1% from RMB29.07 billion in 2003 to RMB32.00 billion in 2004, and represented 67.4% of total GSM service revenue as compared with 70.6% in 2003. For the same reasons, monthly fees decreased by 1.7%, from RMB7.04 billion in 2003 to RMB6.92 billion in 2004, and represented 14.6% of total GSM service revenue as compared with 17.1% in 2003. Interconnection revenue increased by 35.7% from RMB1.93 billion in 2003 to RMB2.61 billion in 2004, and represented 5.5% of total service revenue as compared with 4.7% in 2003.

While continuing to meet the diverse needs of our customers in the mass market, our GSM cellular business aims to actively pursue mid- to high-end customers through the development and promotion of value-added services. Revenue from our GSM value-added cellular services increased 134.8%, from RMB2.07 billion in 2003 to RMB4.86 billion in 2004. Its share of total GSM service revenue more than doubled from 5.0% in 2003 to 10.2% in 2004. Of the total revenue from GSM value-added cellular services, revenue from short messaging services increased 103.6% from RMB1.37 billion in 2003 to RMB2.79 billion in 2004, and its share of total GSM service revenue grew from 3.3% in 2003 to 5.9% in 2004. Revenue from value-added services contributed significantly to the increase of our total GSM cellular revenue and, we believe, will continue to enhance our competitiveness in this business.

*CDMA Cellular Business.* Since we launched CDMA cellular services in 2002, our CDMA subscriber base has expanded rapidly as the market became more familiar with our CDMA services. In 2004, the growth in our CDMA subscriber base greatly boosted revenue from the CDMA cellular business. Revenue from our CDMA cellular business reached RMB26.05 billion in 2004, a 44.2% increase over RMB18.06 billion in 2003. This increase was primarily due to the rapid expansion of our CDMA cellular business as well as the effect of including revenue attributable to Unicom New World, which we acquired effective December 31, 2003. Our CDMA marketing strategy, which seeks to differentiate our CDMA services from our GSM services, has resulted in a rapid increase in the CDMA subscriber base, while successfully positioning the CDMA business in the marketplace as enterprise, infotainment, health-conscious and trendy services. ARPU for our CDMA cellular business reached RMB85.3 in 2004, more than 72.7% higher than the ARPU of RMB49.4 for GSM cellular services.

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The table below sets forth the revenue composition of our CDMA cellular business and each revenue item's respective share of total CDMA revenue for the years ended December 31, 2002, 2003 and 2004.

|                                      | 2002 (Restated) |                        |   | 2003 (Restated) |                        |   | 2004 (Restated) |                        |   |
|--------------------------------------|-----------------|------------------------|---|-----------------|------------------------|---|-----------------|------------------------|---|
|                                      | RMB in million  | As percentage of total |   | RMB in million  | As percentage of total |   | RMB in million  | As percentage of total |   |
| Revenue                              | 3,496           | 100.0                  | % | 18,063          | 100.0                  | % | 26,046          | 100.0                  | % |
| Service Revenue                      | 3,222           | 92.2                   | % | 16,667          | 92.3                   | % | 24,378          | 93.6                   | % |
| Usage Fee                            | 2,231           | 63.8                   | % | 11,672          | 64.6                   | % | 16,165          | 62.1                   | % |
| Monthly Fee                          | 713             | 20.4                   | % | 3,488           | 19.3                   | % | 4,638           | 17.8                   | % |
| Interconnection Revenue              | 184             | 5.3                    | % | 608             | 3.4                    | % | 927             | 3.6                    | % |
| Others                               | 94              | 2.7                    | % | 899             | 5.0                    | % | 2,648           | 10.1                   | % |
| Sales of Telecommunications Products | 274             | 7.8                    | % | 1,396           | 7.7                    | % | 1,668           | 6.4                    | % |

CDMA usage fees increased by 38.5% from RMB11.67 billion in 2003 to RMB16.17 billion in 2004, and represented 66.3% of total CDMA service revenue as compared with 70.0% in 2003. Monthly fees increased by 33.0%, from RMB3.49 billion in 2003 to RMB4.64 billion in 2004, and represented 19.0% of total CDMA service revenue as compared with 20.9% in 2003. Interconnection revenue increased by 52.5% from RMB0.61 billion in 2003 to RMB0.93 billion in 2004, and represented 3.8% of total service revenue as compared with 3.6% in 2003.

With the expansion of our CDMA 1X wireless data services in 2004, we have been actively developing our CDMA wireless data business, by making efforts to convert the competitive edge of the CDMA technology into a competitive edge in operations in order to enhance competitiveness in the market and our appeal to subscribers. Revenue from value-added CDMA cellular services reached RMB2.38 billion in 2004, an increase of 205.1% from RMB0.78 billion in 2003, and accounted for 9.8% of total service revenue from the CDMA cellular business in 2004. We expect revenue from value-added CDMA services will continue to grow significantly, as we will continue to focus on the development and marketing of such value-added services.

***Long Distance and Data and Internet Revenue***

Revenue from our long distance and data and Internet businesses reached RMB5.53 billion, a decrease of 3.6% from 2003. We intend to continue to leverage on our multi-business integrated network platform and actively promote services with distinctive features such as Ruyi Mailbox, UNI-VIDEO and U-Net.

*Long Distance Business.* Revenue from our traditional public switched long distance business decreased by 19.1%, from RMB2.29 billion in 2003 to RMB1.85 billion in 2004. Such decrease is primarily due to increased competition and the decrease in interconnection revenue from Unicom New World caused by our acquisition of Unicom New World.

*Data and Internet Business.* We have fully leveraged the technological advantage of our multi-businesses integrated network platform. Along with effectively expanding international and domestic call volume for IP telephony services, we have been targeting institutional subscribers and corporate subscribers in promoting services with distinctive features such as UNI-VIDEO and U-Net, and we also have been targeting the mass market in promoting data and Internet services such as Ruyi Mailbox. At the same time, we have been continuing to develop integrated data, voice and video connection services, and dedicated and dial-up connection services. As a result of these efforts, revenue from our data and Internet businesses rose by 6.8% from RMB3.44 billion in 2003 to RMB3.68 billion in 2004.



**Paging Revenue**

We sold our paging business to Unicom Group, effective December 31, 2003, and therefore did not have revenue from the paging business in 2004. See Acquisitions of Unicom New Century, Unicom New World and Unicom International and Sale of Guoxin Paging above. See also A. The History and Development of the Company Acquisitions of Unicom New Century and Unicom New World and Sale of Guoxin Paging under Item 4 above.

**Costs and Expenses**

Costs and expenses in 2004 were RMB72.62 billion, representing an increase of 19.1% over 2003, which was greater than the 17.8% growth in revenue for the same period. As discussed below, a 71.3% increase in leased lines and network capacities expenses, a 27.9% increase in selling and marketing expenses, a 16.2% increase in depreciation and amortization expenses and a 27.0% increase in interconnection charges were the primary factors in the increase in costs and expenses. Due to the rapid expansion of our CDMA business, selling and marketing expenses (which include the amortized portion of deferred customer acquisition costs under special promotional packages with certain CDMA contractual subscribers) and leased lines and network capacities expenses (which include the expenses from the CDMA network leases) increased faster than our revenue in 2004. As our various business segments continued to develop, interconnection charges also increased faster than our revenue in 2004 since the interconnection rates remain unchanged while our effective tariffs have been declining due to continued price competition. In addition, depreciation and amortization expenses increased primarily due to the expansion of the scale of our fixed assets. Our costs and expenses as a percentage of total revenue increased to 91.8% in 2004, as compared with 90.8% in 2003. Since late 2004, we have emphasized the business strategy of "effective growth", i.e., profit-driven growth, and will continue to focus on cost control and optimization of our expense structure in order to ensure continued growth in earnings.

The table below illustrates the major expense items from 2002, 2003 and 2004 and their respective shares of total revenue.

|  | For the year ended December 31, |                    |   |                 |                    |   |                 |                    |   |
|--|---------------------------------|--------------------|---|-----------------|--------------------|---|-----------------|--------------------|---|
|  | 2002 (Restated)                 |                    |   | 2003 (Restated) |                    |   | 2004 (Restated) |                    |   |
|  | RMB in million                  | % of Total Revenue |   | RMB in million  | % of Total Revenue |   | RMB in million  | % of Total Revenue |   |
| Costs and expenses   | 33,932                          | 84.3               | % | 60,956          | 90.8               | % | 72,616          | 91.8               | % |
| Leased lines and network capacities                                  | 1,583                           | 3.9                | % | 4,320           | 6.4                | % | 7,398           | 9.4                | % |
| Interconnection charges  | 3,230                           | 8.0                | % | 5,921           | 8.8                | % | 7,517           | 9.5                | % |
| Depreciation and amortization  | 11,256                          | 28.0               | % | 16,359          | 24.4               | % | 19,011          | 24.0               | % |
| Employee benefit expenses  | 3,335                           | 8.3                | % | 4,596           | 6.8                | % | 4,615           | 5.8                | % |
| Selling and marketing  | 5,986                           | 14.9               | % | 15,264          | 22.7               | % | 19,523          | 24.7               | % |
| General, administrative and other expenses                           | 5,632                           | 14.0               | % | 9,139           | 13.7               | % | 10,500          | 13.3               | % |
| Include: Impairment loss and assets write-off of the Paging Business | 116                             | 0.3                | % | 557             | 0.8                | % |                 | 0.0                | % |
| Cost of telecommunications products sold                             | 1,890                           | 4.7                | % | 2,939           | 4.4                | % | 2,563           | 3.2                | % |
| Loss on sale of discontinued operation (Guoxin Paging)               |                                 | 0.0                | % | 663             | 1.0                | % |                 | 0.0                | % |
| Finance costs  | 1,496                           | 3.7                | % | 1,946           | 2.9                | % | 1,696           | 2.1                | % |
| Interest income  | -470                            | -1.2               | % | -173            | -0.3               | % | -103            | -0.1               | % |
| Other gains, net   | -6                              | 0.0                | % | -18             | 0.0                | % | -104            | -0.1               | % |



*Leased Lines and Network Capacities.* With the significant increase in our CDMA subscribers, the lease expense for CDMA network capacities increased by 87.4%, from RMB3.52 billion in 2003 to RMB6.59 billion in 2004. In addition, the effect of including leased line expenses for transmission lines used by Unicom New World we acquired effective December 31, 2003 also contributed to the increase in our leased line expenses. As result, the aggregate amount of our leased line expenses and network capacity lease expenses increased to RMB7.40 billion, representing an increase of 71.3% from RMB4.32 billion in 2003. Leased lines and network capacities expenses as a percentage of total revenue rose from 6.4% in 2003 to 9.4% in 2004.

*Interconnection Charges.* Interconnection charges reached RMB7.52 billion in 2004, representing an increase of 27.0% from 2003, primarily due to the increase in interconnection traffic volume as a result of the development of our GSM and CDMA cellular business and long distance, data and Internet businesses, as well as the effect of including interconnection expenses of Unicom New World, which we acquired effective December 31, 2003. Interconnection charges for our CDMA cellular business increased by 65.9%. Interconnection charges increased by 17.8% for our GSM cellular business. Interconnection charges for long distance, data and Internet business increased by 23.6%. As our various business segments continued to develop, interconnection charges as a percentage of total revenue also increased from 8.8% in 2003 to 9.5% in 2004.

*Depreciation and Amortization.* Depreciation and amortization expenses increased by 16.2% to RMB19.01 billion in 2004, a lower growth rate than the growth in revenue. The increase in depreciation and amortization expenses resulted from expanded network capacity, the expansion of assets scale and the effect of including depreciation expenses attributable to Unicom New World, which we acquired on December 31, 2003. Depreciation and amortization expenses as a percentage of total revenue decreased slightly from 24.4% in 2003 to 24.0% in 2004.

*Employee Benefit Expenses.* As of the end of 2004, we had 39,589 employees, an increase of 2.2% from 38,728 at the end of 2003 (including employees in the nine provinces, autonomous regions and municipalities we acquired through Unicom New World at the end of 2003). Our employee benefit expenses slightly increased from RMB4.60 billion in 2003 to RMB4.62 billion in 2004. Its share as a percentage of total revenue dropped from 6.8% in 2003 to 5.8% in 2004. In order to align the interest of our employees with that of our shareholders, we have set up an employee share option scheme and granted options to qualified employees. During 2003 and 2004, total share options involving 105,956,000 and 113,322,000 shares in our company were granted under the share option scheme respectively.

*Selling and Marketing.* Our major selling and marketing expenses included commissions, promotion and advertising expenses and amortization of customer acquisition costs of contractual CDMA subscribers. Selling and marketing expenses totaled RMB19.52 billion in 2004, an increase of 27.9% from 2003. Amortization of CDMA subscribers acquisition costs in 2004 were RMB6.12 billion, an increase of 4.9% from 2003. The balance of unamortized deferred CDMA subscriber acquisition costs increased from RMB4.04 billion as of the end of 2003 to RMB4.75 billion as of the end of 2004 primarily due to continued offering of CDMA handset promotion packages as a result of intense competitive pressure. Due to the continued growth in the subscriber base of our various business segments (including the effect of our acquisition of Unicom New World), the commissions to distributors and sales agents rose to RMB9.91 billion, an increase of 35.9%. Promotion and advertising expenses were RMB2.37 billion, an increase of 16.2%. Selling and marketing expenses as a percentage of revenue increased from 22.7% in 2003 to 24.7% in 2004.

*General, Administrative and Other Expenses.* Our general, administrative and other expenses were RMB10.50 billion in 2004, representing an increase of 14.9% from RMB9.14 billion in 2003. General, administrative and other expenses as a percentage of total revenue decreased slightly from 13.7% in 2003 to 13.3% in 2004. In 2004, the provision for doubtful debts was RMB2.19 billion, an increase of 25.1% from 2003. Provision for doubtful debts as a percentage of service revenue increased slightly from 2.6% in 2003 to 2.8% in 2004. This has also contributed to the increase in our general, administrative and other expenses.

*Cost of Telecommunications Products Sold.* The cost of telecommunication products sold decreased by 12.9% from RMB2.94 billion in 2003 to RMB2.56 billion in 2004. The share of cost of telecommunications products sold as a percentage of revenue decreased from 4.4% in 2003 to 3.2% in 2004.

*Interest Income and Finance Costs.* Our interest income decreased from RMB0.17 billion in 2003 to RMB0.10 billion in 2004, mainly resulting from a reduction in our cash and cash equivalents. Our finance costs decreased from RMB1.95 billion in 2003 to RMB1.70 billion in 2004, primarily due to an effective reduction in interest expenses as a result of our borrowing of syndicated loans to repay the long-term bank loans. The above factors resulted in net finance costs of RMB1.59 billion in 2004, a decrease of 10.1% from the net finance costs of RMB1.77 billion in 2003.

#### ***Segment income (loss) before income tax***

In 2004, our revenue increased by 17.8%, while our costs and expenses increased by 19.1%. As a result, our income before income tax reached RMB6.47 billion, an increase of 4.4% from 2003, and our income before taxation margin decreased from 9.2% in 2003 to 8.2% in 2004.

*GSM Cellular Business.* In our GSM cellular business, segment income before income tax was RMB6.83 billion in 2004, which is a decrease of 4.1% from 2003. The decrease in the segment income before income tax of our GSM cellular business mainly reflects the 12.3% decline in the ARPU for our GSM cellular business, which was partially offset by the 6.5% increase in the average monthly MOU per subscriber. The decrease in ARPU resulted from intense competition with our main competitor as well as the Little Smart services. In addition, while there was a net addition of 11.70 million subscribers to our GSM services in 2004, a sizable number of subscribers terminated their GSM services with us, contributing to significant increase in our marketing cost. Our segment income before taxation margin in the GSM cellular business decreased from 17.3% in 2003 to 14.3% in 2004.

*CDMA Cellular Business.* We incurred a segment loss before income tax of RMB0.56 billion in 2004 for our CDMA business as compared with the segment loss before income tax of RMB0.30 billion in 2003. The increase of segment loss before income tax of our CDMA cellular business was primarily due to the 32.2% decrease in ARPU as a result of intense competition, the significant increase in lease expenses for our CDMA network capacities as a result of the growth of our customer base, the continued high level of marketing expenses and the significant increase in interconnection charges. After taking into consideration of the improper accounting recordings and errors we identified in our Jiangxi and Xinjiang branches as described in Item 15 Controls and procedures, the segment losses before income tax of our CDMA business for 2004 and 2003 would have been RMB0.44 billion and RMB0.41 billion, respectively.

*Long Distance Business.* In our long distance business, segment income before income tax decreased 23.5%, from RMB0.65 billion in 2003 to RMB0.50 billion in 2004, primarily because of reduced tariff level as a result of increased competition and a reduction in the interconnection revenue after we acquired Unicom New World in December 2003. As a result, the segment income before taxation margin in our long distance business decreased from 20.5% in 2003 to 15.9% in 2004.

*Data and Internet Business.* In our data and Internet businesses, we had a segment loss before income tax of RMB0.07 billion in 2004, compared with segment income before income tax of RMB0.68 billion in 2003. This change was primarily due to reduced tariff level as a result of increased competition.

***Net Income***

*Income Tax.* Our income tax increased to RMB1.98 billion in 2004, an increase of 2.5% from 2003. Our effective tax rates in 2003 and 2004 were 31.1% and 30.6%, respectively. The lower effective tax rate in 2004, as compared with 2003, was mainly due to write-off of previously recognized deferred tax assets of Guoxin Paging after the sale of Guoxin Paging in 2003.

*Net Income.* For reasons analyzed in the above discussion, our net income was RMB4.49 billion in 2004, representing an increase of 5.3% from 2003. Net income per share increased 5.9%, from RMB0.34 in 2003 to RMB0.36 in 2004.

***Impact of Differences between HKFRS and US GAAP***

In addition to the above management discussion and analysis of our results of the operation under HKFRS between the years ended December 31, 2004 and 2003, in connection with the preparation and reconciliation of our consolidated financial statements in accordance with US GAAP, we believe the following significant accounting differences between HKFRS and US GAAP would have a significant impact on our management discussion and analysis of the results of our operation between the years ended December 31, 2004 and 2003.

Under HKFRS, the acquisitions of Unicom International in September 2004 and of Unicom New World on December 31, 2003 have been accounted for under the purchase method. Accordingly, the acquired results of operations have been incorporated into our operating results only from the date of the acquisition. In contrast, under US GAAP, our acquisitions of Unicom International and Unicom New World have been accounted for as a transfer of businesses under common control. Under this method, the acquired assets and liabilities have been accounted for at historical cost under US GAAP and the consolidated financial statements prepared under US GAAP for all periods presented have been retroactively restated as if Unicom International and Unicom New World had always been part of our company.

Under HKFRS, the sale of Guoxin Paging to the Unicom Group is accounted for as a sale of discontinued operation. The difference between the sale proceeds and the carrying amount of net assets of Guoxin Paging as of December 31, 2003 was recorded as a loss on sale of discontinued operation in our consolidated income statement for the year ended December 31, 2003. The operating results of Guoxin Paging from January 1, 2003 to the effective date of the sale of Guoxin Paging were included in our consolidated income statement for the year ended December 31, 2003. Under US GAAP, the sale of Guoxin Paging is considered a transfer of business between entities under common control and accounted for at historical cost of the net assets transferred, after reduction, if appropriate, for an indicated impairment of value. In addition, under US GAAP, the results of operations of a component or segment of an entity that has been disposed of should be reported in discontinued operations as a separate component of income, separately from continuing operations, in the period in which the disposal occurred and in prior periods. Accordingly, all the operating results of Guoxin Paging have been grouped into and reported in the income statement as Discontinued operation Loss from discontinued operation under US GAAP.

Other than the above, there are no major material differences between HKFRS and US GAAP that would have a significant impact on the discussion and analysis of our results of operations between the years ended December 31, 2004 and 2003. Taking into account the operating results of the acquired business and the disposed business, our combined revenue under US GAAP increased from RMB71.98 billion in 2003, to RMB79.39 billion in 2004, representing an increase of 10.3%. Our net income under US GAAP decreased from RMB4.74 billion in 2003 to RMB4.71 billion in 2004, representing a decrease of 0.5%. See also Note 37 to the consolidated financial statements for a more detailed summary of all significant accounting differences between HKFRS and US GAAP that are relevant to us.

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

As of the end of 2005, we had RMB5.47 billion of cash and cash equivalents and RMB0.28 billion of short-term bank deposits. As of the end of 2005, we had working capital deficit (current assets minus current liabilities) of RMB35.59 billion, compared to working capital deficit of RMB28.88 billion at the end of 2004. The decrease in working capital resulted primarily from the issuance of RMB10.0 billion short-term bonds in 2005, which was partially offset by the decrease in current portion of long-term bank loans. In view of our credit worthiness and the current availability of funds in China and Hong Kong, we believe that we will have access to debt and equity financing, in particular bank financing in the PRC and elsewhere, which together with net cash inflows from operations will be sufficient to fund our capital and liquidity needs.

The following table sets forth cash inflows and outflows in 2003, 2004 and 2005.

|  | For the year ended December 31, |           |           |
|--|---------------------------------|-----------|-----------|
|  | 2003                            | 2004      | 2005      |
|  | (RMB in millions)               |           |           |
| Net cash inflows from operating activities           | 22,565                          | 23,819    | 30,804    |
| Net cash outflows from investing activities          | (19,051 )                       | (18,958 ) | (16,748 ) |
| Net cash inflows before financing activities         | 3,514                           | 4,861     | 14,056    |
| Net cash outflows from financing activities          | (8,778 )                        | (9,401 )  | (13,213 ) |
| Net (decrease)/increase in cash and cash equivalents | (5,264 )                        | (4,540 )  | 843       |

Net cash inflows from operating activities increased by 29.3%, from RMB23.82 billion in 2004 to RMB30.80 billion, mainly reflecting the growth in our business.

Net cash outflows from investing activities were RMB16.75 billion in 2005, compared to RMB18.96 billion in 2004. This decrease in net cash outflows from investing activities in 2005 primarily resulted from our effort to control capital investment and reduce investment cost.

Net cash outflows from financing activities were RMB13.21 billion in 2005, an increase of 40.6% from the outflow of RMB9.40 billion in 2004, resulting primarily from an increase in repayment of short-term bank loans, from RMB12.27 billion in 2004 to RMB20.10 billion in 2005 as we attempted to further optimize our debt structure.

**Indebtedness and Capital Structure**

The following table sets forth the amount of cash, assets, short-term and long-term debt, equity as well as debt-to-assets and debt-to-equity ratios as of the end of 2003, 2004 and 2005.

|   | As of December 31,                    |                |         |
|---|---------------------------------------|----------------|---------|
|   | 2003(Restated)                        | 2004(Restated) | 2005    |
|   | (RMB in millions, except percentages) |                |         |
| Cash and cash equivalent and short-term bank deposits | 10,133                                | 5,317          | 5,754   |
| Total assets  | 152,870                               | 149,038        | 142,630 |
| Short-term debt                                       | 18,173                                | 20,015         | 22,035  |
| Long-term debt  | 36,213                                | 26,137         | 11,982  |
| Shareholders' equity                                  | 69,052                                | 72,442         | 76,287  |
| Debt-to-assets ratio(1)                               | 44.1                                  | % 38.9         | % 30.8  |
| Debt-to-equity ratio(2)                               | 78.8                                  | % 63.7         | % 44.6  |

(1) Debt-to-assets ratio = (long term debt + short term interest bearing debt)/(long term debt + short term interest bearing debt + shareholders' equity).

(2) Debt-to-equity ratio = (long term debt + short term interest bearing debt)/shareholders' equity.

Our debt-to-assets ratio decreased from 38.9% at the end of 2004 to 30.8% at the end of 2005. Our debt-to-equity ratio decreased from 63.7% at the end of 2004 to 44.6% at the end of 2005. The sum of our long-term and short-term interest bearing debt exceeded the amount of our cash and cash equivalents and short-term bank deposits by RMB28.3 billion as of December 31, 2005. We continue to seek to optimize our capital structure, develop multiple financing sources and reduce overall financing costs.

Outstanding short-term and long-term bank loans, denominated in RMB or the U.S. dollar, decreased from RMB46.15 billion at the end of 2004 to RMB34.02 billion at the end of 2005 primarily due to our efforts to optimize our debt structure by paying off bank loans that have become due. Our long-term bank loans generally bear floating interest rates that ranged from US\$ LIBOR plus 0.28% to 0.44% per annum in 2005 with maturity through 2010. The loan agreements do not include financial performance or other covenants which materially restrict our operations or those of CUCL, our principal operating subsidiary in China. As of December 31, 2005, no short-term bank loans or long-term bank loans were guaranteed by Unicom Group.

We finance a significant portion of our business operations and capital expenditures with short-term and long-term debt. We have established and maintained high credit ratings among PRC financial institutions. In view of our creditworthiness and the current availability of funds in China, we believe that we are able to continue to obtain sufficient financing from PRC financial institutions. If, however, we are unable to roll over, extend or refinance in a timely manner a significant amount of our short-term borrowings, we may be unable to meet our debt service and other obligations.

Our long-term debt has declined in recent years, while the level of our short-term debt has been generally stable. In order to further rationalize our debt structure and reduce our interest expense, we will continue to finance a portion of our business operations and capital expenditures through short-term borrowings. Our liquidity in the future will primarily depend on our ability to maintain adequate cash inflow from operations and obtain adequate external financing to meet our debt service obligations and planned capital expenditures. Our operating cash flows could be adversely affected by numerous factors beyond our control, including but not limited to changes in telecommunication tariffs, decreased demand for our telecommunication services and further intensified competition. Our ability to obtain external financing also depends on numerous factors, including but not limited to our financial condition and creditworthiness as well as our relationship with lenders. See **D. Risk Factors Risks Relating to Our Business**. We may be unable to fund our capital expenditure and debt service requirements, which may adversely affect our financial condition and growth prospects. under Item 3.

In September 2003 we entered into a US\$700 million term loan facility with 13 financial institutions, which is consisted of three tranches: a three-year US\$200 million tranche, with an interest rate of 0.28% over the US\$ LIBOR per annum, a five-year US\$300 million tranche, with an interest rate of 0.35% over the US\$ LIBOR per annum, and a seven-year US\$200 million tranche, with an interest rate of 0.44% over the US\$ LIBOR per annum.

In February 2004, our operating entity, CUCL, entered into a US\$500 million term loan facility with 12 financial institutions, which is repayable in three years at an interest rate of 0.40% over the US\$ LIBOR per annum.

In July 2005, CUCL completed an offering of two tranches of short-term bonds in the PRC interbank debenture market. The first tranche of the bonds was issued for an aggregate amount of RMB9.0 billion with a maturity period of 365 days. The second tranche of the bonds was issued for an aggregate amount of RMB1.0 billion with a maturity period of 180 days. The effective interest rate as at December 31, 2005 was 2.89%.

In June 2006, CUCL applied to the People's Bank of China, or the PBOC, for an offering of short-term commercial paper, with term of repayment not exceeding 365 days and the total cumulative outstanding amount not exceeding 40% of the net assets of CUCL as set out in the most recent audited financial statements of CUCL. Such offering can be made at any time within one year after the completion of registration of the application with the PBOC.

#### ***Contractual Obligations and Commercial Commitments***

The following tables set forth the amount of our outstanding contractual cash obligations as of December 31, 2005.

| Contractual Obligations                      | Payments Due by Period (RMB in millions) |               |              |              |             |              |                |              |  |
|--|--|---------------|--------------|--------------|-------------|--------------|----------------|--------------|--|
|  | Total                                    | Due in 2006   | Due in 2007  | Due in 2008  | Due in 2009 | Due in 2010  | Due after 2010 |              |  |
| Long-term bank loans(1)                      | 17,127                                   | 5,145         | 6,138        | 3,502        | 353         | 1,989        |                |              |  |
| Finance lease obligations(2)                 | 566                                      | 421           | 144          | 1            |             |              |                |              |  |
| Interest payment obligations on bank loans   | 812                                      | 565           | 153          | 59           | 30          | 5            |                |              |  |
| Capital commitments(3)                       | 4,209                                    | 4,209         |              |              |             |              |                |              |  |
| Operating leases(3)                          |  |               |              |              |             |              |                |              |  |
| CDMA network capacity leasing arrangement(4) | 7,132                                    | 7,132         |              |              |             |              |                |              |  |
| Others                                       | 3,934                                    | 747           | 597          | 511          | 476         | 435          |                | 1,168        |  |
| Other commitments(3)(5)                      | 1,232                                    | 1,232         |              |              |             |              |                |              |  |
| <b>Total obligations</b>                     | <b>34,978</b>                            | <b>19,445</b> | <b>7,021</b> | <b>4,062</b> | <b>853</b>  | <b>2,429</b> |                | <b>1,168</b> |  |



- (1) See Note 15 Long-term Bank Loans to our consolidated financial statements.
- (2) See Note 16 Obligations Under Finance Leases to our consolidated financial statements.
- (3) See Note 33 Contingencies and Commitments to our consolidated financial statements.
- (4) We entered into the CDMA network capacity leasing arrangement with Unicom Group and its subsidiary Unicom New Horizon by our wholly-owned subsidiaries, CUCL (including Unicom New Century, which was merged into CUCL on July 20, 2004, and Unicom New World, which was merged into CUCL on September 1, 2005) in our cellular service areas. See Note 33.2 Contingencies and Commitments Operating Lease Commitment to our consolidated financial statements for details.
- (5) Other commitments represented our commitment to purchase CDMA handsets from vendors. See Note 33.3 Contingencies and Commitments Commitment to purchase CDMA handsets to our consolidated financial statements for details.

#### *Off-balance Sheet Arrangements*

As of December 31, 2005, except for the operating lease for CDMA network capacity set forth above in Contractual Obligations and Commercial Commitments, we did not have any other off-balance sheet arrangements.

We operate our CDMA cellular business based on the CDMA network capacity we have leased from Unicom New Horizon, a wholly-owned subsidiary of Unicom Group. Such CDMA network capacity leasing arrangement is important to us in respect of our liquidity, capital resources, market risk support and credit risk support. The details of the CDMA network capacity leasing arrangement are described in B. Business Overview Cellular Services CDMA Cellular Services Our Lease of CDMA Networks from Unicom Group under Item 4; Critical Accounting Policies Lease of CDMA Network Capacity under Item 5; B. Related Party Transactions Leasing of CDMA Network Capacity under Item 7 and Note 4.2(b) Leasing of CDMA Network Capacity and Note 33.2 Contingencies and Commitments Operating Lease Commitments to our consolidated financial statements. There is no known event, demand, commitment, trend or uncertainty that will or is reasonably likely to result in the termination, or material reduction in availability to us, of the CDMA network capacity lease arrangement.

#### *Capital Expenditures*

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

|                                  | For the years ended December 31, |       |       |
|----------------------------------|----------------------------------|-------|-------|
|                                  | 2004                             | 2005  | 2006  |
|                                  | (RMB in billions)                |       |       |
| Cellular(1)                      | 6.40                             | 7.33  | 10.80 |
| Long distance, data and Internet | 1.34                             | 1.18  | 1.47  |
| Transmission network(2)          | 3.06                             | 2.95  | 3.78  |
| Others(3)                        | 7.59                             | 6.15  | 5.95  |
| Total                            | 18.39                            | 17.61 | 22.00 |

(1) The capital expenditures for 2004 onwards represent 30 provinces, municipalities and autonomous regions, including the 9 provinces and autonomous regions which we acquired at the end of 2003.

(2) Expenditures on transmission network refer to investment in the inter-province and intra-province backbone transmission network, the local network and the access network.

(3) Other expenditures represent investment in telecom equipment buildings, supporting systems and miscellaneous items.

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Capital expenditures in 2005 totaled RMB17.61 billion. Capital expenditures attributable to the GSM cellular business, the long distance, data and Internet businesses, the transmission network and other projects were RMB7.33 billion, RMB1.18 billion, RMB2.95 billion, and RMB6.15 billion, respectively. Expenditures for other projects were mainly related to the set-up of the billing, customer service and information system, office building, construction of integrated access network and miscellaneous purchases.

Projected capital expenditures for 2006 is RMB22.00 billion, which will be used primarily for improving and upgrading the GSM networks and for billing systems, customer services and information technology system.

We expect to fund our capital expenditure needs through a combination of cash generated from operating activities, short-term and long-term borrowings and other debt and equity financing. See D. Risk Factors Risks Relating to Our Business We may be unable to fund our capital expenditure and debt service requirements, which may adversely affect our financial condition and growth prospects under Item 3.

#### **US GAAP Reconciliation**

Our consolidated financial statements are prepared in accordance with HKFRS, which differs in certain material respects from US GAAP. Differences relate primarily to the effect of the acquisitions of Unicom New Century, Unicom New World and Unicom International and the sale of Guoxin Paging, employees housing benefits, revaluation of properties performed in connection with the reorganization, capacity transaction of leased lines and recognition of employee compensation costs under share options scheme. Reconciliation between HKFRS and US GAAP which affect our net income and shareholders equity arising from the aforementioned differences are included in Note 37 to the consolidated financial statements included in this annual report. In addition, additional disclosures on the condensed financial information under US GAAP, including condensed statements of income, changes in shareholders equity and cash flows information, as well as condensed balance sheets information and other additional financial information which have been restated for relevant periods presented to reflect the impact of the effects of the acquisitions of Unicom New Century, Unicom New World and Unicom International and the sale of Guoxin Paging under common control are included in Note 37 to the consolidated financial statements presented in this annual report.

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

The following table sets forth certain information concerning our current directors and executive officers.

| Name                  | Age | Position  |
|-----------------------|-----|---|
| Chang Xiaobing        | 49  | Chairman of the Board of Directors; Executive Director; Chief Executive Officer |
| Shang Bing            | 50  | Executive Director; President   |
| Tong Jilu             | 48  | Executive Director; Chief Financial Officer                                     |
| Li Jianguo            | 52  | Executive Director  |
| Yang Xiaowei          | 42  | Executive Director; Vice President  |
| Li Zhengmao           | 43  | Executive Director; Vice President  |
| Li Gang               | 48  | Executive Director; Vice President  |
| Zhang Junan           | 50  | Executive Director; Vice President  |
| Lu Jianguo            | 60  | Non-Executive Director  |
| Wu Jinglian           | 76  | Independent Non-Executive Director  |
| Shan Weijian          | 52  | Independent Non-Executive Director  |
| Linus Cheung Wing Lam | 58  | Independent Non-Executive Director  |
| Wong Wai Ming         | 48  | Independent Non-Executive Director  |

Chang Xiaobing was appointed in December 2004 as an Executive Director, Chairman of the Board of Directors and Chief Executive Officer of the Company. Mr. Chang, a professor-level senior engineer, graduated in 1982 from the Nanjing Institute of Posts and Telecommunications with a B.S. degree in telecommunications engineering and received a master's degree in business administration from Tsinghua University in 2001. He received a doctor's degree in business administration from the Hong Kong Polytechnic University in 2005. Prior to joining the Unicom Group, Mr. Chang served as a Deputy Director of the Nanjing Municipal Posts and Telecommunications Bureau and a Deputy Director General of the Directorate General of Telecommunications of the Ministry of Posts and Telecommunications and a Deputy Director General and Director General of the Department of Telecommunications Administration of the MII, as well as Vice President of China Telecom Group. Mr. Chang was appointed the Chairman of Unicom Group in November 2004. He also serves as the Chairman of the A Share Company and CUCL, respectively. Mr. Chang has 24 years of operational and managerial experience in the telecommunications industry in China.

Shang Bing was appointed in November 2004 as an Executive Director and President of the Company. Mr. Shang, a senior economist, graduated in 1982 from Shenyang Chemical Industry Institution with a bachelor's degree in chemical industry and received a master's degree in business administration from New York State University. He received a doctor's degree in business administration from the Hong Kong Polytechnic University in 2005. From 1986 to 1998, Mr. Shang served as a Director of Industrial Technology Development Centre in Liaoning Province, Deputy General Manager and General Manager of Economic and Technological Development Company in Liaoning Province. Mr. Shang joined Unicom Group in August 1998. From 1998 to 2001, Mr. Shang served as Deputy General Manager and General Manager of Unicom Group Liaoning Branch. Mr. Shang was appointed a Vice President of Unicom Group in March 2001 and became a Director and Vice President of Unicom Group in September 2003. Mr. Shang was appointed the President of Unicom Group in November 2004. At present, Mr. Shang is also a Director of Unicom Group, a Director and President of the A Share Company and a Director and President of CUCL. Mr. Shang has extensive management experience and knowledge in telecommunications operations.

Tong Jilu was appointed in February 2004 as an Executive Director and Chief Financial Officer of the Company. He assists the President in handling issues relating to finance. Mr. Tong graduated in 1987 from the Department of Economic Management at the Beijing University of Posts and Telecommunications. He received a master's degree in business administration from National University of Australia in 2002 and is an Executive Director of the Association of Chief Accountants and Vice Chairman of Internal Audit Association of China. From August 1989 to October 1998, he served first as a Deputy Director and later as a Director of the Finance Bureau of the Posts and Telecommunications Administration of Liaoning Province. From November 1998 to June 2000, Mr. Tong served as Deputy Director General of the Posts and Telecommunications Administration and the Posts Office of Liaoning Province. Mr. Tong joined Unicom Group in July 2000 and served as Chief Accountant of Unicom Group from July 2000 to February 2001. Since March 2001, Mr. Tong has served as Vice President of Unicom Group. He has served as a Director in the Unicom Group since September 2003 and the Chief Accounting Officer of the Unicom Group since December 2004. Mr. Tong is also a Director in the A Share Company and a Director and Vice President in CUCL. Mr. Tong has extensive experience in management of telecommunications companies and finance management of listed companies.

Li Jianguo was appointed in April 2006 as an Executive Director of the Company. She graduated from the Chemical Engineering Department of the Xiangtan University in 1982. Ms. Li is a senior economist and held leading positions in various enterprises, local governments and state ministries and committees for a significant period of time. She joined the Unicom Group in June 2000 and has been the Chairlady of the labor union of the Unicom Group since December 2001 and a Director of the Unicom Group since September 2003. Ms. Li is also a Director of CUCL and the Chairman of the board of supervisors of the A Share Company. Ms. Li has extensive experience in working for the government and enterprises and in management.

Yang Xiaowei was appointed in April 2006 as an Executive Director and Vice President of the Company. He received a bachelor's degree from the Computer Application Department of Chongqing University in 1998 and a master's degree in engineering from the Management Engineering Department of Chongqing University in 2001. Mr. Yang is a senior engineer. From December 1992 to January 2002, Mr. Yang held the positions of Assistant to Director and Deputy Director of Chongqing Telecommunications Bureau, Deputy Director of the Chongqing Telecommunications Administration Bureau and Director of Chongqing Municipal Communication Administration Bureau. Mr. Yang joined the Unicom Group in January 2002 and served as General Manager of the Chongqing branch and the Guangdong branch of the Unicom Group. He has been Vice President of the Unicom Group since December 2003 and Director of the Unicom Group since December 2004. Mr. Yang is also a Director and Vice President of CUCL. Mr. Yang has extensive experience in management and the telecommunications industry.

Li Zhengmao was appointed in April 2006 as an Executive Director and Vice President of the Company. He received a doctor's degree in electronic engineering from the Southeast University in 1988. From 1992 to 1994, he was a Professor of the University of Electronic Science and Technology of China. Mr. Li joined the Unicom Group in August 1994 and held various positions in the Unicom Group, including Deputy Head of the Network Technology Department, Head of the Wireless Communication Department, Head of the Technology Department and Deputy Chief Engineer. From April 2000 to May 2002, he was Executive Director and Vice President of the Company. From May 2002 to December 2003, he was General Manager of the Yunnan branch of the Unicom Group. Mr. Li has been Vice President of the Unicom Group since December 2003 and has been a Director of the Unicom Group since December 2004. Mr. Li also serves as the Director and Vice President of CUCL, the Chairman of Unisk (Beijing) Information Technology Co. Ltd. and Unicom-BREW Wireless Technologies Ltd. Mr. Li has extensive experience in engineering technology and business operations.

Li Gang was appointed in April 2006 as an Executive Director and Vice President of the Company. He graduated from Beijing University of Posts and Telecommunications in 1985 and received a master's degree in business administration from the Department of Advanced Business Administration of Jinan University in 2004. Mr. Li is a senior engineer and previously served as Deputy Director of the Telecommunications Division, Deputy Director of the Telecommunications Department, Deputy Director of the Rural Telephone Bureau, Deputy Director and Director of the Telecommunications Operation and Maintenance Department of the Posts and Telecommunications Administration Bureau in Guangdong Province and as Director of the Mobile Communication Bureau. From 1999 to 2005, he served as Vice Chairman, General Manager and Chairman of Guangdong Mobile Communication Co., Ltd. and as Chairman and General Manager of Beijing Mobile Communication Co., Ltd. From 2000 to 2005, he also served as Executive Director of China Mobile (Hong Kong) Limited. Mr. Li joined the Unicom Group in December 2005 and is currently Vice President of the Unicom Group. Mr. Li is also a Director and Vice President of CUCL, the Chairman of Unicom Huasheng Communications Technology Co. Ltd. and Unicom Xin Guo Xin Communications Ltd. Mr. Li has worked in the telecommunications industry for a long period of time and has extensive management experience.

Zhang Junan was appointed in April 2006 as an Executive Director and Vice President of the Company. He graduated from the Nanjing University of Posts and Telecommunications majoring in carrier communication in 1982. He received a master's degree in business administration from National Australian University in 2002. Mr. Zhang is a senior engineer. He previously served as Director of the Bengbu Municipal Posts and Telecommunications Bureau in Anhui Province and Deputy Director of the Anhui Provincial Posts and Telecommunications Bureau. From 2000 to 2005, he served as Deputy General Manager and General Manager of the Anhui Provincial Telecommunications Company and the Chairman and General Manager of Anhui Provincial Telecommunications Co., Ltd. Mr. Zhang joined the Unicom Group as Vice President in December 2005. Mr. Zhang also serves as a Director and Vice President of CUCL. Mr. Zhang has worked in the telecommunications industry for a long period of time and has extensive management experience.

Lu Jianguo was appointed in April 2006 as a Non-Executive Director of the Company. He is an engineer. He graduated from the PLA Air Force Academy of Engineering in 1968 majoring in radio. From 1988 to 1994, he served as Director of Beijing Long Distance Call Bureau, Deputy Director-General of the Communication Department of the Posts and Telecommunications Ministry, Deputy Director of Office of State Radio Regulatory Commission. Mr. Lu served as Vice President of the Unicom Group from October 1994 to December 2005 and Director of the Unicom Group from February 2000 to December 2005 and is currently also a Director of the A Share Company. Mr. Lu is experienced in telecommunications operations and has extensive management experience.

Wu Jinglian was appointed in April 2000 as an Independent Non-Executive Director of the Company. Mr. Wu is a senior researcher at the Development Research Center of the State Council, or DRC, and a professor at the Graduate School of the Chinese Academy of Social Sciences and China Europe International Business School. Mr. Wu graduated from Fudan University and received honorary doctoral degrees in Social Science from the University of Hong Kong and the Hong Kong Baptist University in 2005 and 2000, respectively. Mr. Wu was previously an Executive Director of the DRC and Deputy Director of the Programming Office for Economic Reform of the State Council. Mr. Wu has been a visiting scholar at Yale University, a visiting professor at the Asia-Pacific Research Center of Stanford University and a visiting researcher at the Massachusetts Institute of Technology.

Shan Weijian was appointed in May 2003 as an Independent Non-Executive Director. Mr. Shan is a Co-Managing Partner of Newbridge Capital Limited. Mr. Shan serves on the boards of BOC Hong Kong (Holdings) Limited, TCC International Holdings Limited and Baoshan Iron and Steel Company Limited, among others. Before joining Newbridge, Mr. Shan was a Managing Director of J.P. Morgan. Prior to that, he taught at the Wharton School of Business at University of Pennsylvania. His earlier employers include the World Bank, Grahman and James, a law firm based in San Francisco, and Beijing University of International Business and Economics. Mr. Shan received a Ph.D. degree from the University of California, Berkeley.

Linus Cheung Wing Lam was appointed in May 2004 as an Independent Non-Executive Director of the Company. Before this, Mr. Cheung was Deputy Chairman of PCCW Limited. Prior to the merger of Pacific Century Cyberworks Limited and Cable & Wireless HKT Limited, or Hongkong Telecom, Mr. Cheung was the Chief Executive of Hongkong Telecom and an Executive Director of Cable & Wireless plc in the United Kingdom. Mr. Cheung also worked at Cathay Pacific Airways for 23 years before departing as Deputy Managing Director. He was appointed an Official Justice of the Peace in 1990 and a Non-official Justice of the Peace in 1992. Mr. Cheung is currently a member of the Chinese People's Political Consultative Conference for the Tianjin Municipal Government. Mr. Cheung received a bachelor's degree in social science and a diploma in management studies from the University of Hong Kong. He is also an Honorary Fellow of the University of Hong Kong and of The Chartered Institute of Marketing in the United Kingdom.

Wong Wai Ming was appointed in January 2006 as an Independent Non-Executive Director of the Company. Mr. Wong is an Executive Director and Chief Executive Officer of Roly International Holdings Limited and an Executive Director of Linmark. Mr. Wong is also an Independent Non-Executive Director of Lenovo Group Limited and I.T Limited. Prior to his current executive position, he was an Executive Director and Chief Executive Officer of the Sing Tao News Corporation Limited. Before joining Sing Tao News Corporation, he worked as an investment banker with more than 15 years of experience in investment banking business in Greater China and was a member of the Listing Committee of The Stock Exchange of Hong Kong Limited. Mr. Wong is a chartered accountant and holds a bachelor of science degree (with Honors) in management science from the Victoria University of Manchester in the United Kingdom.

## ***B. Compensation***

The aggregate compensation paid by us to our directors and executive officers as a group in 2005 was approximately RMB19.21 million, including retirement and other benefits. Each of our executive directors and executive officers participated in a bonus scheme with us that ties the amount of bonus he or she will receive at the end of a year to our operating results of the year and his or her job performance. Some of our directors also hold options to purchase shares in our company. See **E. Share Ownership** below for detailed descriptions of our share option schemes and options granted to our directors and executive officers as well as compensation for the year 2005.

**C. Board Practices****General**

Pursuant to our Articles of Association, at each annual general meeting, one-third of our directors retire from office by rotation. The retiring Directors are eligible for re-election. The Board may at any time appoint a new director to fill a vacancy or as an additional director. The Board may also appoint and remove our executive officers. No benefits are payable to our directors or executive officers upon termination of their service with us in accordance with the provisions of their service agreements, except certain statutory compensation. The following table sets forth certain information concerning our current directors and former directors who served as directors in 2005.

| Name                     | Appointment Date  | Re-appointment Date                               | Resignation Date |
|--------------------------|-------------------|---|------------------|
| <b>Current Directors</b> |                   |   |                  |
| Chang Xiaobing           | December 21, 2004 | May 12, 2006                                      |                  |
| Shang Bing               | November 5, 2004  | May 12, 2005                                      |                  |
| Tong Jilu                | February 1, 2004  | May 12, 2004 and<br>May 12, 2006                  |                  |
| Li Jianguo               | April 1, 2006     | May 12, 2006                                      |                  |
| Yang Xiaowei             | April 1, 2006     | May 12, 2006                                      |                  |
| Li Zhengmao              | April 1, 2006     | May 12, 2006                                      |                  |
| Li Gang                  | April 1, 2006     | May 12, 2006                                      |                  |
| Zhang Junan              | April 1, 2006     | May 12, 2006                                      |                  |
| Lu Jianguo               | April 1, 2006     | May 12, 2006                                      |                  |
| Wu Jinglian              | April 20, 2000    | May 13, 2002,<br>May 12, 2004 and<br>May 12, 2005 |                  |
| Shan Weijian             | May 12, 2003      | May 12, 2005                                      |                  |
| Cheung Wing Lam, Linus   | May 12, 2004      | May 12, 2006                                      |                  |
| Wong Wai Ming            | January 19, 2006  | May 12, 2006                                      |                  |
| <b>Former Directors</b>  |                   |   |                  |
| Zhao Le                  |                   |   | July 19, 2005    |
| Li Qiuhong               | July 19, 2005     |   | April 1, 2006    |
| Lo Wing Yan, William     |                   |   | April 1, 2006    |
| Ye Fengping              |                   |   | April 1, 2006    |
| Liu Yunjie               |                   |   | April 1, 2006    |
| Craig O. McCaw           |                   |   | May 12, 2005     |
| C. James Judson(1)       |                   |   | May 12, 2005     |

(1) Mr. Judson was an alternate director to Mr. McCaw.



### **Audit Committee**

The audit committee reviews and supervises our financial reporting process and internal financial controls. The duties of the audit committee include, among others:

- considering and approving the appointment, resignation and removal of our external auditor and the auditor's fees;
- reviewing our interim and annual financial statements and disclosure before submission to the board of directors;
- discussing with the auditor any problems and reservations arising from the audit of the interim and final results;
- reviewing any correspondence from the auditor to the management and the responses of the management;
- reviewing the relevant reports concerning our internal controls and procedures;
- pre-approving the audit and non-audit services to be provided by the external auditor, and determining whether any non-audit services would affect the independence of the auditor; and
- discussing with the management the timing and procedures for the rotation of the partner of the auditing firm responsible for the audit of our company and the partner responsible for the review of audit related documents.

The Board of Directors recently approved certain amendments to the duties of the audit committee, including strengthening of responsibilities in the following areas:

- supervising the internal audit department, which will directly report to the committee; and
- having the right to approve the appointment or removal of the head of internal audit department.

As of May 31, 2006, the members of the audit committee are Wong Wai Ming, Chairman of the committee, Wu Jinglian, Shan Weijian and Linus Cheung Wing Lam.

### **Remuneration Committee**

The remuneration committee meets regularly to consider human resources issues, issuance of share options and other matters relating to compensation. In particular, the remuneration committee makes recommendations to the Board on executive compensation. The primary duties of the remuneration committee are to make recommendations to the Board regarding the remuneration structure of the executive directors and to determine specific remuneration packages for the executive directors on behalf of the board. The remuneration committee is also responsible for operating our employee share option scheme and any other incentive scheme as they apply to the executive directors, including determining the granting of options to executive directors. As of May 31, 2006, the members of the remuneration committee are Wu Jinglian, Chairman of the committee, Lu Jianguo and Linus Cheung Wing Lam.

**D. Employees**

As of December 31, 2003, 2004 and 2005, we had 38,728, 39,589, and 53,070 employees, respectively. These employees as of December 31, 2005 are classified by function as follows:

| By Function                                    | Number of Employees | By Business Segment | Number of Employees |
|--|---------------------|---------------------|---------------------|
| Management and administration                  | 7,898               | Cellular            | 45,931              |
| Other general administration                   | 9,426               | GSM                 | 29,877              |
| Marketing and sales                            | 15,743              | CDMA                | 16,054              |
| Technical, engineering and network maintenance | 14,509              | Long distance       | 2,322               |
| Retail and customer service                    | 2,348               | Data and Internet   | 4,817               |
| General support                                | 3,146               | <b>Total</b>        | 53,070              |
| <b>Total</b>                                   | 53,070              |                     |                     |

As of December 31, 2005, we also employed approximately 80,000 temporary employees.

**E. Share Ownership**

As of May 31, 2006, except for Mr. Li Zhengmao who holds 20,000 shares of our company, our directors and executive officers as a group do not own any shares in our company.

As of May 31, 2006, our directors and executive officers as a group hold options for 13,353,600 shares, or less than 0.1% of our issued and outstanding share capital, including the following options granted under our pre-global offering share option scheme and share option scheme:

*Options granted under the share option scheme*

| Name            | Number of Shares Covered | Expiration Date   | Exercise Price | Consideration Paid | Compensation for 2005 (RMB) |
|-----------------|--------------------------|-------------------|----------------|--------------------|-----------------------------|
| Chang Xiaobing  | 526,000                  | December 20, 2010 | HK\$6.20       | HK\$1.00           | 4,213,000                   |
|                 | 800,000#                 | February 14, 2012 | HK\$6.35       | HK\$1.00           |                             |
| Shang Bing      | 292,000                  | July 9, 2008      | HK\$6.18       | HK\$1.00           | 3,513,000                   |
|                 | 292,000                  | May 20, 2009      | HK\$4.30       | HK\$1.00           |                             |
|                 | 292,000                  | July 19, 2010     | HK\$5.92       | HK\$1.00           |                             |
|                 | 128,000                  | December 20, 2010 | HK\$6.20       | HK\$1.00           |                             |
| Tong Jilu       | 700,000#                 | February 14, 2012 | HK\$6.35       | HK\$1.00           |                             |
|                 | 292,000                  | July 9, 2008      | HK\$6.18       | HK\$1.00           | 2,845,000                   |
|                 | 292,000                  | May 20, 2009      | HK\$4.30       | HK\$1.00           |                             |
|                 | 292,000                  | June 21, 2010     | HK\$15.42      | HK\$1.00           |                             |
|                 | 292,000                  | July 19, 2010     | HK\$5.92       | HK\$1.00           |                             |
| Li Jianguo(1)   | 500,000#                 | February 14, 2012 | HK\$6.35       | HK\$1.00           |                             |
|                 | 176,000                  | July 9, 2008      | HK\$6.18       | HK\$1.00           | —                           |
|                 | 292,000                  | May 20, 2009      | HK\$4.30       | HK\$1.00           |                             |
|                 | 292,000                  | June 21, 2010     | HK\$15.42      | HK\$1.00           |                             |
|                 | 292,000                  | July 19, 2010     | HK\$5.92       | HK\$1.00           |                             |
| Yang Xiaowei(2) | 500,000#                 | February 14, 2012 | HK\$6.35       | HK\$1.00           |                             |
|                 | 122,000                  | July 9, 2008      | HK\$6.18       | HK\$1.00           | —                           |
|                 | 204,000                  | May 20, 2009      | HK\$4.30       | HK\$1.00           |                             |
|                 | 292,000                  | July 19, 2010     | HK\$5.92       | HK\$1.00           |                             |
| Li Zhengmao(3)  | 500,000#                 | February 14, 2012 | HK\$6.35       | HK\$1.00           |                             |
|                 | 176,000                  | July 9, 2008      | HK\$6.18       | HK\$1.00           | —                           |
|                 | 100,000                  | May 20, 2009      | HK\$4.30       | HK\$1.00           |                             |
|                 | 292,000                  | July 19, 2010     | HK\$5.92       | HK\$1.00           |                             |

500,000#

February 14, 2012

HK\$6.35

HK\$1.00

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| Name                         | Number of Shares Covered | Expiration Date   | Exercise Price | Consideration Paid | Compensation for 2005 (RMB) |
|------------------------------|--------------------------|-------------------|----------------|--------------------|-----------------------------|
| Li Gang(4)                   | 500,000#                 | February 14, 2012 | HK\$6.35       | HK\$1.00           | —                           |
| Zhang Junan(5)               | 500,000#                 | February 14, 2012 | HK\$6.35       | HK\$1.00           | —                           |
| Lu Jianguo(6)                | 292,000                  | July 9, 2008      | HK\$6.18       | HK\$1.00           | —                           |
|                              | 292,000                  | May 20, 2009      | HK\$4.30       | HK\$1.00           |                             |
|                              | 292,000                  | July 19, 2010     | HK\$5.92       | HK\$1.00           |                             |
|                              | 500,000#                 | February 14, 2012 | HK\$6.35       | HK\$1.00           |                             |
| Wu Jinglian                  | 292,000                  | July 9, 2008      | HK\$6.18       | HK\$1.00           | 316,000                     |
|                              | 292,000                  | May 20, 2009      | HK\$4.30       | HK\$1.00           |                             |
|                              | 292,000                  | July 19, 2010     | HK\$5.92       | HK\$1.00           |                             |
| Shan Weijian                 | 292,000                  | May 20, 2009      | HK\$4.30       | HK\$1.00           | 316,000                     |
|                              | 292,000                  | July 19, 2010     | HK\$5.92       | HK\$1.00           |                             |
| Cheung Wing Lam, Linus       | 292,000                  | July 19, 2010     | HK\$5.92       | HK\$1.00           | 316,000                     |
| Wong Wai Ming(7)             | —                        | —                 | —              | —                  | —                           |
| Li Qihong(8)(15)             | 204,000                  | July 9, 2008      | HK\$6.18       | HK\$1.00           | 1,013,000                   |
|                              | 204,000                  | May 20, 2009      | HK\$4.30       | HK\$1.00           |                             |
|                              | 204,000                  | July 19, 2010     | HK\$5.92       | HK\$1.00           |                             |
|                              | 280,000#                 | February 14, 2012 | HK\$6.35       | HK\$1.00           |                             |
| Zhao Le(9)(15)               | 136,000                  | July 9, 2008      | HK\$6.18       | HK\$1.00           | 1,226,000                   |
|                              | 204,000                  | May 20, 2009      | HK\$4.30       | HK\$1.00           |                             |
|                              | 272,000                  | July 19, 2010     | HK\$5.92       | HK\$1.00           |                             |
| Lo Wing Yan, William(10)(15) | 88,000                   | May 20, 2009      | HK\$4.30       | HK\$1.00           | 2,877,000                   |
|                              | 262,000                  | July 19, 2010     | HK\$5.92       | HK\$1.00           |                             |
|                              | 280,000#                 | February 14, 2012 | HK\$6.35       | HK\$1.00           |                             |
| Ye Fengping(11)(15)          | 132,000                  | July 9, 2008      | HK\$6.18       | HK\$1.00           | 2,145,000                   |
|                              | 204,000                  | May 20, 2009      | HK\$4.30       | HK\$1.00           |                             |
|                              | 136,000                  | June 21, 2010     | HK\$15.42      | HK\$1.00           |                             |
|                              | 262,000                  | July 19, 2010     | HK\$5.92       | HK\$1.00           |                             |
|                              | 280,000#                 | February 14, 2012 | HK\$6.35       | HK\$1.00           |                             |
| Liu Yunjie(12)(15)           | 292,000                  | May 20, 2009      | HK\$4.30       | HK\$1.00           | 316,000                     |
|                              | 292,000                  | July 19, 2010     | HK\$5.92       | HK\$1.00           |                             |
| Craig O. McCaw(13)(15)       | 292,000                  | July 9, 2008      | HK\$6.18       | HK\$1.00           | 114,000                     |
|                              | 292,000                  | May 20, 2009      | HK\$4.30       | HK\$1.00           |                             |
|                              | 292,000                  | July 19, 2010     | HK\$5.92       | HK\$1.00           |                             |
| C. James Judson(14)(15)      | —                        | —                 | —              | —                  | —                           |

- (1) Ms. Li was appointed as Executive Director of our company on April 1, 2006.
- (2) Mr. Yang was appointed as Executive Director and Vice President of our company on April 1, 2006.
- (3) Mr. Li was appointed as Executive Director and Vice President of our company on April 1, 2006.
- (4) Mr. Li was appointed as Executive Director and Vice President of our company on April 1, 2006.
- (5) Mr. Zhang was appointed as Executive Director and Vice President of our company on April 1, 2006.
- (6) Mr. Lu was appointed as Non-Executive Director of our company on April 1, 2006.
- (7) Mr. Wong was appointed as Independent Non-Executive Director of our company on January 19, 2006.
- (8) Mr. Li was appointed as Executive Director and Vice President of our company on July 19, 2005 and resigned as Executive Director of our company on April 1, 2006.

- (9) Mr. Zhao resigned as Executive Director and Vice President of our company on July 19, 2005.
- (10) Mr. Lo resigned as Executive Director and Vice President of our company on April 1, 2006.
- (11) Mr. Ye resigned as Executive Director and Vice President of our company on April 1, 2006.
- (12) Mr. Liu resigned as Non-Executive Director of our company on April 1, 2006.
- (13) Mr. McCaw retired as Independent Non-Executive Director on May 12, 2005.
- (14) Mr. Judson was an alternate director to Mr. McCaw.
- (15) For the directors who resigned during the year 2005 or 2006, the numbers of options indicated represent the numbers of options held by the respective directors as of their dates of resignation.

# Granted in 2006.

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*Options granted under the pre-global offering share option scheme*

| Name           | Number of Shares Covered | Expiration Date | Subscription Price | Consideration Paid |
|----------------|--------------------------|-----------------|--------------------|--------------------|
| Shang Bing     | 204,400                  | June 21, 2010   | HK\$15.42          | HK\$1.00           |
| Li Zhengmao(1) | 292,600                  | June 21, 2010   | HK\$15.42          | HK\$1.00           |
| Lu Jianguo(2)  | 292,600                  | June 21, 2010   | HK\$15.42          | HK\$1.00           |
| Li Qihong(3)   | 204,400                  | June 21, 2010   | HK\$15.42          | HK\$1.00           |
| Zhao Le(4)     | 204,400                  | June 21, 2010   | HK\$15.42          | HK\$1.00           |
| Liu Yunjie(5)  | 292,600                  | June 21, 2010   | HK\$15.42          | HK\$1.00           |

- (1) Mr. Li was appointed as Executive Director and Vice President of our company on April 1, 2006.
- (2) Mr. Lu was appointed as Non-Executive Director of our company on April 1, 2006.
- (3) Mr. Li was appointed as Executive Director and Vice President of our company on July 19, 2005 and resigned as Executive Director on April 1, 2006.
- (4) Mr. Zhao resigned as Executive Director and Vice President of our company on July 19, 2005.
- (5) Mr. Liu resigned as Non-Executive Director of our company on April 1, 2006.

**Stock Incentive Schemes**

We retained a compensation consulting firm to help us design stock incentive schemes that align the interests of our management and employees with those of our shareholders and link their compensation with our operating results and share performance.

*Share Option Scheme.* We adopted a share option scheme on June 1, 2000 and amended the scheme on May 13, 2002. The amended scheme provides for the grant of options to our employees, including executive directors and non-executive directors. Any grant of share options to a connected person (as defined in the HKSE Listing Rules) of Unicom requires approval by our independent non-executive directors, excluding any independent non-executive director who is the grantee of the option. We plan to grant options that cover a total number of ordinary shares not exceeding 10% of the total number of our issued and outstanding shares as of May 13, 2002. The option period commences on any date after the date on which an option is offered, but may not exceed 10 years from the offer date. The subscription price of a share in respect of any particular option granted under this share option scheme will be determined by our board of directors in its discretion at the grant date, which shall be no less than the higher of: (i) the nominal value of the shares; (ii) the closing price of the shares on the Hong Kong Stock Exchange on the grant date in respect of such option; and (iii) the average closing price of the shares on the Hong Kong Stock Exchange for the five trading days immediately preceding the grant date. As of May 31, 2006, 413,802,000 options granted by us were outstanding and held by 12 directors and 2,900 of our employees. As of May 31, 2006, 10,714,000 options with an exercise price of HK\$6.18, 18,631,200 options with an exercise price of HK\$4.3, 154,000 options with an exercise price of HK\$4.65 and 2,920,000 options with an exercise price of HK\$5.92 had been exercised.

*Pre-Global Offering Share Option Scheme.* We also adopted a pre-global offering share option scheme on June 1, 2000. As of May 31, 2006, 24,309,600 options granted by us were outstanding and held by 3 directors and approximately 250 of our employees. We do not expect to grant further options under this scheme. On May 13, 2002, this scheme was amended along with the amendment of the share option scheme described above. The amended terms of the pre-global offering share option scheme are substantially the same as the share option scheme, except for the following:

- The subscription price of a share in respect of any particular option granted under the pre-global offering share option scheme is HK\$15.42, the offer price in the Hong Kong public offering portion of our initial public offering, excluding brokerage fees and transaction levy.
- The period during which an option may be exercised commences two years from the date of grant and ends 10 years from June 22, 2000.

As of May 31, 2006, no options granted under this scheme had been exercised.

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

### **A. Major Shareholders**

As of May 31, 2006, our controlling shareholder, Unicom Group, through its 17.90% direct interest in Unicom BVI, and its majority-owned subsidiary, China United Telecommunications Corporation Limited, which in turn holds 82.10% of Unicom BVI, beneficially owned 6,590,546,000 shares of Unicom, or 52.36% of our total outstanding shares. See *A. History and Development of the Company* under Item 4 above. Unicom Group's shares are held by the SASAC and a group of thirteen companies, most of which are state-owned enterprises in China. Shares beneficially owned by Unicom Group do not carry voting rights different from our other issued shares.

As of May 31, 2006, most of our record shareholders were located outside of the United States. In addition, as of May 31, 2006, there were approximately 26 million ADSs outstanding, each representing 10 shares and together representing 2.1% of our total outstanding shares or 4.3% of our total outstanding shares not held by our controlling shareholder.

### **B. Related Party Transactions**

Principal transactions between us and our controlling shareholder, Unicom Group, include the following categories:

- leasing of CDMA network capacity by us from Unicom Group and related interconnection and roaming arrangements;
- provision of ongoing telecommunications and ancillary services and premises;
- agreements relating to the acquisition of Unicom International from Unicom Group;
- agreements relating to the acquisition of Unicom New World from Unicom Group and the sale of Guoxin Paging to Unicom Group;
- agreements relating to the restructuring in connection with the acquisition of Unicom New Century from Unicom Group; and
- agreements relating to the restructuring in connection with our initial public offering.

### **Leasing of CDMA Network Capacity**

#### *Old CDMA Lease*

Under the Old CDMA Leases, Unicom New Horizon agreed to lease capacity on its CDMA network to each of CUCL, Unicom New Century and Unicom New World in their respective cellular service areas. In 2004, our total lease fee payment under the Old CDMA Leases was RMB6.59 billion.





Under the Old CDMA Leases, Unicom New Horizon agreed to plan, finance and construct the CDMA network, including the procurement of all equipment, and to ensure that the CDMA network was constructed in accordance with the detailed specifications and timetable agreed between Unicom New Horizon and us. All payments, costs, expenses and amounts paid or incurred by Unicom New Horizon that were directly attributable to the construction of the CDMA network form the total network construction cost, which was used in calculating the lease fee payable by us, including:

- construction, installation and equipment procurement costs and expenses,
- survey and design costs,
- investment in technology, software and other intangible assets,
- insurance premiums and capitalized interest on loans,
- any taxes levied or paid in respect of the procurement of equipment and the construction of the CDMA network, including import taxes and custom duties, and
- all costs incurred in relation to any upgrade of technology.

The Old CDMA Leases required that the network construction cost be verified and appropriate documentation provided to us or our auditors for verification. The lease fee was calculated so as to enable Unicom New Horizon to recover its total network construction cost within seven years, together with an internal rate of return of 8%.

We were responsible for the operation, management and maintenance of the CDMA network in accordance with the relevant requirements of the Old CDMA Leases and had the exclusive right to provide CDMA services in our cellular service areas. All revenue, including airtime charges, monthly subscription fees, interconnection charges, income from sales of UIM cards and handsets and other income generated from or in connection with the operation of the CDMA network belonged to us. All costs of operating and managing the CDMA network and all maintenance costs of a non-capital nature should be borne by us except that constructed capacity related costs (i.e. those costs of operating and managing the CDMA network which related directly to the constructed capacity on the CDMA network, including the rental fees for stations and base stations and related expenses including water and electricity charges, heating charges and fuel charges for the relevant equipment etc., as well as maintenance costs of a non-capital nature) should be borne by us only to the extent of such part of the costs that corresponded to the proportion of capacity actually leased under the Old CDMA Leases. Such part of the Constructed Capacity Related Costs that corresponded to the proportion of capacity not actually leased under the Old CDMA Leases should be borne by Unicom New Horizon.

In addition to the capacity that we agreed to lease in the first term, subject to giving not less than 180 days prior notice to Unicom New Horizon, we could request to lease additional capacity. Unicom New Horizon was required to ensure that all capacity which we had so requested was supplied by the due date of delivery of the capacity, provided that, unless otherwise agreed, Unicom New Horizon would not be obliged to expand the CDMA network beyond a certain limit. We could not reduce the amount of capacity leased during the initial one-year lease term. However, subject to providing not less than 180 days prior written notice to or with the prior written consent of Unicom New Horizon, we could reduce the amount of capacity leased for any additional lease term, provided that we must lease all capacity which we had requested or otherwise committed to lease for at least one year following the date of delivery or renewal of the lease of such capacity.

Subject to certain exceptions, including delay caused by a force majeure event, a material breach of the Old CDMA Leases by us or compliance with applicable laws and regulations, if any capacity was not ready for operational service by the relevant delivery date, then Unicom New Horizon should be liable to provide a delay discount to us, equal to the daily lease fee in respect of the relevant capacity multiplied by the number of days of delay, which should be credited against future lease fee payments.

We had the option to purchase the CDMA network, which could be exercised at any time during the initial lease term or any additional lease term of the lease and within one year thereafter. The acquisition price would be negotiated between Unicom New Horizon and us, based on the appraised value of the CDMA network determined by an independent assets appraiser in accordance with applicable PRC laws and regulations and taking account of prevailing market conditions and other factors, provided that it would not exceed such price as would, taking into account all lease fee payments made by us to Unicom New Horizon and all delay discounts of lease fee, enable Unicom New Horizon to recover its total network construction cost, together with an internal rate of return on its investment of 8%. The exercise of the purchase option would be subject to the relevant laws, regulations and listing rules in Hong Kong and the PRC, particularly those governing connected transactions. Title to the CDMA network assets would remain vested in Unicom New Horizon until the CDMA network assets were transferred to us following exercise of the purchase option.

In consideration of our entering into the Old CDMA Leases, Unicom Group unconditionally and irrevocably guaranteed the due and punctual performance by Unicom New Horizon of its obligations under the Old CDMA Leases. Unicom Group also agreed to indemnify us for any loss suffered as a result of any defect in any of the equipment or any loss caused by any negligence, default, act or omission of Unicom New Horizon or Unicom Group under the Old CDMA Leases or in connection with the CDMA network. The aggregate liability of Unicom Group for any claim should not exceed the total amount of lease fee payments made to Unicom New Horizon and, where the purchase option had been exercised, the total purchase price paid for the CDMA network. The guarantee and indemnity provided by Unicom Group under the Old CDMA Leases would continue in force until the expiration of the relevant Old CDMA Lease.

We could terminate the Old CDMA Leases by not less than 180 days prior written notice, with effect from the end of any additional term. In addition, Unicom Group or we could terminate an Old CDMA Lease if the other committed any continuing or material breach of the relevant Old CDMA Leases. Unicom Group or Unicom New Horizon was not otherwise permitted to terminate the lease.

#### *New CDMA Lease*

On March 24, 2005, we entered into a new CDMA lease agreement, or New CDMA Lease, with Unicom Group and its subsidiary Unicom New Horizon to replace the Old CDMA Lease. The New CDMA Lease has an initial term of two years commencing January 1, 2005 and may be renewed at our option. The length of each renewed term shall be agreed by all parties to the New CDMA Lease.

Under the New CDMA Lease, Unicom New Horizon has agreed to lease all constructed capacity of its CDMA network to us and the lease fee for the CDMA network will be as follows:

- in 2005, 29% of the audited annual service revenue generated by our CDMA cellular business, or CDMA Business Income; and
- in 2006, 30% of the CDMA Business Income;

provided that the annual lease fee may not be less than a certain minimum level. The minimum lease fee for 2005 was 90% of the total amount of lease fee paid by us to Unicom New Horizon pursuant to the Old CDMA Leases for 2004. The minimum lease fee for 2006 will be 90% of the total amount of lease fee paid by us to Unicom New Horizon pursuant to the New CDMA Lease for 2005. The lease fee arrangements for any renewed term of the New CDMA Lease will be subject to negotiations among the parties to the New CDMA Lease. In 2005, our total lease fee payment under the New CDMA Lease was RMB7.92 billion.

Subject to certain exceptions, including delay caused by a force majeure event (including natural disasters, national emergencies, civil disturbances, riots, acts of terrorism, industrial disputes and other similar events beyond the control of the parties), a material breach of the New CDMA Lease by us or compliance with applicable laws and regulations, if Unicom New Horizon fails to provide any capacity of its CDMA network which affects the provision of services by us, Unicom New Horizon shall be liable to provide a discount for delay to us, calculated pursuant to the following formula:

$$\begin{array}{l} \text{Discount for} \\ \text{delay} \end{array} = \begin{array}{l} \text{Number of our CDMA} \\ \text{subscribers affected by} \\ \text{the delay} \end{array} \times \begin{array}{l} \text{delay period} \\ \text{(number of days)} \end{array} \times \begin{array}{l} \text{ARPU of CDMA} \\ \text{subscribers} \\ \text{the number of days in} \\ \text{the relevant month} \end{array}$$

In the above formula, number of our CDMA subscribers affected by the delay shall be confirmed by us on the basis of substantive evidence; ARPU of CDMA subscribers shall be the average monthly ARPU figure of the CDMA subscribers in the relevant areas for the three months immediately prior to the delay, as calculated and confirmed by us.

The proportion of the constructed capacity related costs to be borne by us shall be calculated by reference to the actual number of our cumulative CDMA subscribers at the end of the month prior to the occurrence of the costs divided by 90%, as a percentage of the total amount of capacity (expressed in terms of the number of subscribers) constructed on the CDMA network.

The other key terms of the New CDMA Lease, including exclusive operating rights, purchase option, guarantee and indemnity, are substantially similar to those of the Old CDMA Leases.

#### **Provision of Ongoing Telecommunications and Ancillary Services and Premises**

We had entered into a number of service arrangements with Unicom Group and/or its subsidiaries with respect to provision of ongoing telecommunications and ancillary services between Unicom Group and us, including leasing of satellite transmission capacity, supply of international telecommunication network gateway services, supply of various telephone cards, supply of equipment procurement services, supply of cellular subscriber services, supply of customer services, supply of agency services, leasing of transmission line capacity and interconnection and roaming arrangements, as well as provision of premises.

On March 24, 2005, we and Unicom Group entered into a comprehensive services agreement, or the New Comprehensive Services Agreement, a comprehensive operator services agreement, or the New Comprehensive Operator Services Agreement, and a premise leasing agreement, or the New Guoxin Premises Leasing Agreement, to replace the previous service arrangements between Unicom Group and us.

Each of the New Comprehensive Services Agreement, the New Comprehensive Operator Services Agreement and the New Guoxin Premises Leasing Agreement has an initial term of two years commencing on January 1, 2005 and is renewable for further two-year terms at our option.

#### ***Leasing of Satellite Transmission Capacity***

We lease satellite transmission capacity from a 95.00% owned subsidiary of Unicom Group. We use this capacity to supplement our long distance network.

That subsidiary of Unicom Group and CUCL previously entered into a satellite transmission channel leasing agreement, dated May 25, 2000. Under that agreement, payments for leasing of satellite transmission capacity were calculated on the basis of tariffs set by the MII. We paid the minimum applicable tariff for the relevant volume and duration less a discount of up to 10%. The discount would not be less than that offered to any third party leasing similar transmission capacity.

The New Comprehensive Services Agreement, which replaced the satellite transmission channel agreement, contains similar terms with respect to the lease of satellite transmission capacity. The total leasing charges for satellite transmission capacity for 2005 were approximately RMB11.79 million.

***Supply of International Telecommunication Network Gateway Services***

Unicom Group provides us with access to international connections for our international long distance service through its international telecommunication network gateways. CUCL and Unicom Group previously entered into a services agreement, dated May 25, 2000, under which Unicom Group agreed to supply international telecommunication network gateway services to us. Unicom Group has undertaken not to supply international telecommunication network gateway services to third parties. The charges for these services were based on Unicom Group's cost of operation and maintenance of the international telecommunication network gateway facilities, including depreciation, plus a margin of 10% over cost. We retained all revenues generated by our international long distance service.

The New Comprehensive Services Agreement, which replaced the service agreement entered in 2000, contains similar terms with respect to the supply of international telecommunication network gateway services. Total charges for the supply of international telecommunication network gateway services in 2005 were approximately RMB19.80 million.

***Supply of Telephone Cards***

Each of CUCL, Unicom New Century and Unicom New World previously entered into a services agreement with Unicom Group, dated May 25, 2000, November 20, 2002 and November 20, 2003 respectively, to provide for a telephone cards supply arrangement under which, Unicom Group agreed through its subsidiary, Unicom Xingye, to supply various kinds of telephone cards, including SIM cards, UIM cards, IP telephony cards and rechargeable calling cards, to us. Charges for the supply of these cards were based on the actual cost incurred by Unicom Xingye in supplying the cards plus a margin over cost to be agreed upon from time to time, but in any case not to exceed 20%, subject to specified volume discounts. Under these three services agreements, prices and volumes would be reviewed by the parties on an annual basis.

The New Comprehensive Services Agreement, which replaced the previous telephone card supply arrangements, contains similar terms with respect to the supply of telephone cards. Total charges for the supply of telephone cards for 2005 were approximately RMB0.67 billion.

***Supply of Equipment Procurement Services***

Prior to the restructuring in connection with our initial public offering, Unicom Import and Export Co. Ltd., a 95.0% direct subsidiary of Unicom Group, handled most procurement of foreign and domestic telecommunications equipment and other materials required for construction of Unicom Group's networks. Each of CUCL, Unicom New Century and Unicom New World previously entered into a services agreement with Unicom Group, dated May 25, 2000, November 20, 2002 and November 20, 2003 respectively, to provide for this procurement service arrangement under which we were allowed to continue to use Unicom Group's procuring service at the rate of:

- 0.7% of the contract value in the case of imported equipment, or
- 0.5% of the contract value in the case of domestic equipment.

These three agreements were amended on November 22, 2004 so that with effect from July 1, 2004, the above rates were lowered as follows:

- 0.55% of the contract value of those contracts under US\$30 million (including US\$30 million) and 0.35% of the contract value of those procurement contracts over US\$30 million, in the case of imported equipment, or
- 0.25% of the contract value of those contracts under RMB200 million (including RMB 200 million) and 0.15% of the contract value of those contracts over RMB 200 million, in the case of domestic equipment.

In addition, pursuant to this amendment on November 22, 2004, Unicom Group agreed to indemnify us for any loss caused by any negligence, default, act or omission of Unicom Group or Unicom Import and Export Co. Ltd. up to an amount equal to the total amount of agency services fees paid to Unicom Group under the three agreements.

Under the New Comprehensive Services Agreement, Unicom Group agreed to provide us comprehensive procurement services at the same rates as those applied with effect from July 1, 2004 pursuant to the November 22, 2004 amendment mentioned above. Unicom Group has also agreed to continue to agree to indemnify us for any loss caused by any negligence, default, act or omission of Unicom Group or Unicom Import and Export Co. Ltd. up to an amount equal to the total amount of agency services fees paid to Unicom Group under the New Comprehensive Services Agreement. Our total payment to Unicom Group for equipment procurement services for 2005 was approximately RMB15.79 million.

#### *Interconnection Arrangements*

Our various telecommunication networks interconnect with various telecommunication networks of Unicom Group. CUCL previously entered into two services agreements with Unicom Group, dated May 25, 2000 and November 22, 2001, respectively, and each of Unicom New Century and Unicom New World previously entered into a services agreement with Unicom Group, dated November 20, 2002 and November 20, 2003 respectively. These four services agreements provided for our interconnection arrangements with Unicom Group, under which interconnection settlement between Unicom Group's networks and our network was based on relevant standards established from time to time by the MII.

However, in the case of calls between cellular subscribers of different networks in different provinces, settlement was based on either the relevant standards established by the MII or a cost-based internal settlement arrangement applied by Unicom Group prior to the restructuring in connection with our initial public offering, whichever is more favorable to us.

Under the New Comprehensive Services Agreement, interconnection settlements between Unicom Group's networks and our network are as follows:

With respect to cellular calls between different provinces, settlement between the cellular networks of Unicom Group and us will be made by one of the following two methods that is more favorable to us:

- the cellular network from which the outgoing calls originate and the cellular network which receives the incoming calls will each retain 4% of the long distance call fee incurred and the remaining 92% of the long distance call fee will be credited to us; or
- pursuant to the settlement standard stipulated in the Notice Concerning the Issue of the Measures on Settlement of Interconnection between Public Telecommunications Networks and Sharing of Relaying Fees (Xin Bu Dian [2003] No. 454) promulgated by the MII on October 28, 2003, the cellular network from which the outgoing calls originate and the cellular network which receives the incoming calls will each retain RMB0.06 from the long distance call fee. The remaining long distance call fee will be credited to us.

For other interconnection settlement between the networks of Unicom Group and us, both parties agree to conduct settlement in accordance with the relevant provisions in the Notice Concerning the Issue of the Measures on Settlement of Interconnection between Public Telecommunications Networks and Sharing of Relaying Fees (Xin Bu Dian [2003] No. 454) promulgated by the MII on October 28, 2003 (as amended from time to time).

In 2005, interconnection revenue and interconnection expenses derived from the new arrangements with Unicom Group were approximately RMB139.74 million and RMB16.10 million, respectively.

#### ***Roaming Arrangements***

We and Unicom Group provide roaming services to each other. In addition, we make our long distance network available to Unicom Group in its implementation of its roaming arrangements with other operators. CUCL previously entered into two services agreements with Unicom Group, dated May 25, 2000 and November 22, 2001, respectively, and each of Unicom New Century and Unicom New World previously entered into a services agreement with Unicom Group, dated November 20, 2002 and November 20, 2003 respectively. These four services agreements provided for our roaming arrangements with Unicom Group, under which charges for these roaming services between us and Unicom Group were based on our respective internal costs of providing these services, and would be on no less favorable terms than those available to any third party. We received 50% of Unicom Group's roaming revenue from third party operators for calls using our long distance network.

Under the New Comprehensive Services Agreement, the roaming fee arrangements between Unicom Group and us are as follows:

- The cellular subscribers using roaming services will pay roaming fees at the agreed rate of RMB0.60 per minute of roaming usage for both incoming and outgoing calls based on MII guidelines.
- If our cellular subscribers roam in the service areas of Unicom Group, we will be entitled to receive the roaming fees, which will be apportioned in the following way: (i) RMB0.40 (the rate for local call charges under MII guidelines) will be paid to Unicom Group; and (ii) the remaining RMB0.20 will be withheld by us; and
- If the cellular subscribers of Unicom Group roam in our service areas, Unicom Group will be entitled to receive the roaming fees, which will be apportioned in the following way: (i) RMB0.56 will be paid to us; and (ii) RMB0.04 will be withheld by Unicom Group; and
- If the network of a third party cellular network operator is made available to the cellular subscribers of Unicom Group pursuant to the international roaming arrangements of Unicom Group, or if the network of Unicom Group is made available to the subscribers of any third party cellular network operator pursuant to such arrangements, we will receive 50% of all roaming revenue to be received under such international roaming arrangements.

In 2005, roaming revenue and roaming expenses derived from the new arrangements with Unicom Group were approximately RMB67.78 million and approximately RMB41.80 million, respectively.

*Leasing of Transmission Line Capacity*

Unicom Group leases fixed-line transmission capacity from CUCL. CUCL previously entered into a services agreement with Unicom Group, dated May 25, 2000, to provide for this transmission line capacity leasing arrangement under which lease charges were based on tariffs stipulated by the MII from time to time less a discount of up to 10%. The discount given by CUCL to Unicom Group must not be more than what CUCL offered to other third party lessees for a similar lease. When new tariffs were adopted by the MII, the discount rate would be reviewed.

The New Comprehensive Services Agreement contains similar terms with respect to the leasing of transmission line capacity by us to Unicom Group. In 2005, we received from Unicom Group total leasing fees of approximately RMB25.84 million.

#### *Supply of Cellular Subscriber Value-added Services*

Prior to the sale of Guoxin Paging to Unicom Group, it provided operator-based value-added services to our cellular subscribers through its paging network, equipment and operators. Such services include the Unicom Assistant services. Following the sale of Guoxin Paging to Unicom Group at the end of 2003, Unicom Group has agreed to provide (through the successor company to Guoxin Paging) to us cellular subscriber value-added services pursuant to a previous comprehensive operator services agreement dated November 20, 2003. The various local branches of Guoxin Paging and us would agree on the proportion for sharing the revenue derived and actually received by us from such value-added services, provided that the agreed-upon proportion for Guoxin Paging may not be higher than the average agreed-upon proportion for independent value-added telecommunications content providers who provided value-added communications content to us in the same region. The revenue sharing proportions would be adjusted annually.

Under the New Comprehensive Operator Services Agreement, we will retain 40% of the revenue derived and actually received by us from value-added services provided to our subscribers by Unicom Group (through the successor company to Guoxin Paging) and allocate 60% of such revenue to Guoxin Paging, on the condition that such proportion for Guoxin Paging may not be higher than the average agreed-upon proportion for independent value-added telecommunications content providers who provide value-added communications content to us in the same region. In 2005, we made total payment of approximately RMB412.55 million to Unicom Group in 2005 for its supply of cellular subscriber value-added services.

#### *Supply of Customer Services*

Pursuant to a previous comprehensive operator services agreement dated November 20, 2003, Unicom Group has agreed to provide (acting on its own or through Guoxin Paging) to us customer services. These customer services included business inquiries, tariff inquiries, account maintenance, complaints handling, customer interviews and subscriber retention. Service fees payable by us to Unicom Group or Guoxin Paging were calculated on the basis of the costs of the customer service plus a profit margin of no more than 10%. The costs of the customer service were the costs per operator seat multiplied by the number of effectively operating operator seats. The cost per operator seat in economically developed areas, such as Beijing and Shanghai, was the actual cost, i.e., actual wages, administration expenses, operation and maintenance expenses, depreciation of equipment and leasing fees for premises attributable to the customer service in such area for the previous year. The cost per operator seat in other area was agreed upon between the local branches of Guoxin Paging and us, subject to our final confirmation, provided that such cost could not exceed the nationwide (other than Beijing and Shanghai) weighted average of such costs plus 10%. Unicom Group would notify us the number of effectively operating operator seats of each month within 10 days after the end of that month, and then we would confirm that number within five business days based on criteria set forth in the relevant MII regulations.



Under the New Comprehensive Operator Services Agreement, the cost per operator seat in economically developed areas such as Beijing and Shanghai remains to be the actual cost per operator seat, while the cost per operator seat in an area other than economically developed areas will be the lower of the actual cost per operator seat in that area and the nationwide (excluding Beijing and Shanghai) average of actual cost per operator plus 10%. Other than this, the New Comprehensive Services Agreement contains similar terms with respect to the supply of customer services. In 2005, our total payment to Unicom Group for its supply of customer services was RMB562 million.

#### ***Supply of Agency Services***

Pursuant to a previous comprehensive operator services agreement dated November 20, 2003, Unicom Group agreed to provide (through Guoxin Paging) to us subscriber development services, including by telephone or through other channels utilizing Guoxin Paging's paging network, equipment and operators. Agency fees payable by us to Unicom Group or Guoxin Paging could not exceed the average of agency fees payable to any third party agent providing subscriber development services to us in the same region.

The New Comprehensive Operator Services Agreement contains similar terms with respect to the supply of agency services. In 2005, we paid agency fees of approximately RMB15.31 million to Unicom Group for its supply of agency services described above.

#### ***Mutual Provision of Premises***

Unicom Group and CUCL provide to each other premises from time to time pursuant to the services agreement between Unicom Group and CUCL dated May 25, 2000. Unicom Group also provided premises to Unicom New Century and Unicom New World pursuant to services agreements with each of Unicom New Century and Unicom New World dated November 20, 2002 and November 20, 2003, respectively. Other than premises leased from third parties, the rental rates in each case were based on the lower of depreciation costs and market prices for similar premises in that locality, but CUCL could charge Unicom Group market rates for premises leased to Unicom Group. In cases where the premises were leased from a third party, the rental was the amount payable in the head lease. In the case of shared premises, the price was split in proportion to the respective areas occupied by the parties. In connection with our provision of premises to Guoxin Paging, which was effective from January 1, 2004, the rental was based on the higher of depreciation costs and market prices for similar premises in each locality.

The terms in the New Comprehensive Services Agreement with respect to mutual provision of premises and the terms in the New Guoxin Premises Leasing Agreement with respect to our provision of premises to Guoxin Paging are similar to those in the previous agreements. The net charges for premises leased to us by Unicom Group as offset by our charges for premises leased to Unicom Group for 2005 were RMB21.06 million.

#### **Agreements relating to the Acquisition of Unicom International from Unicom Group**

In relation to the acquisition by us of Unicom International from Unicom Group, we and China Unicom (Hong Kong) Group Limited, which is an indirectly wholly-owned subsidiary of Unicom Group, entered into a conditional sale and purchase agreement, dated July 28, 2004. This agreement includes the following terms:

- China Unicom (Hong Kong) Group Limited's agreement to transfer all of its equity interest in Unicom International to us;
- our agreement to pay China Unicom (Hong Kong) Group Limited a cash consideration in the amount of HK\$37,159,995.77; and

- warranties given by China Unicom (Hong Kong) Group Limited to us in relation to Unicom International.

**Agreements relating to the Acquisition of Unicom New World from Unicom Group and the Sale of Guoxin Paging to Unicom Group**

***The Reorganization Agreement***

In relation to the restructuring in connection with the acquisition by us of Unicom New World from Unicom Group, Unicom Group entered into a reorganization agreement with Unicom New World, dated November 4, 2003. This agreement includes the following terms:

- Unicom Group's agreement to transfer to Unicom New World the assets and liabilities attributable to the businesses as described under A. History and Development of the Company-Acquisitions of Unicom New Century and Unicom New World and Sale of Guoxin Paging under Item 4;
- mutual warranties and indemnities given by Unicom Group and Unicom New World in relation to the assets and liabilities transferred to Unicom New World and in relation to the restructuring; and
- undertakings by Unicom Group in favor of Unicom New World, including undertakings:
  - to hold and maintain all licenses received from the MII in connection with any of the transferred businesses for the benefit of Unicom New World, and to allocate spectrum and to provide other resources to Unicom New World;
  - subject to applicable Chinese laws and regulations in effect at the relevant time, to take all actions necessary to obtain, maintain, renew and otherwise extend to or for the benefit of Unicom New World such governmental or regulatory licenses, consents, permits or other approvals as Unicom New World may require to continue to operate its businesses; and
  - not to engage in any business which competes with our businesses except for the existing competing businesses of Unicom Group.

***Conditional Sale and Purchase Agreement with respect to Unicom New World***

In relation to the acquisition by us of Unicom New World from Unicom Group, we and Unicom BVI entered into a conditional sale and purchase agreement, dated November 20, 2003. This agreement includes the following terms:

- Unicom BVI's agreement to transfer all of its equity interest in Unicom New World (BVI) Limited, which holds 100% of the equity interest in Unicom New World, to us;
- our agreement to pay Unicom BVI a cash consideration in the amount of HK\$3,014,886,000 (approximately RMB3.2 billion); and
- warranties given by Unicom BVI to us in relation to Unicom New World.

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***Conditional Sale and Purchase Agreement with respect to Guoxin Paging***

In relation to the sale by us of Guoxin Paging to Unicom Group, CUCL and the A Share Company entered into a conditional sale and purchase agreement, dated November 20, 2003. This agreement includes the following terms:

- CUCL's agreement to sell to the A Share Company, and the A Share Company's agreement to acquire from CUCL, all of CUCL's equity interest in Guoxin Paging;
- the A Share Company's agreement to pay CUCL a cash consideration in the amount of HK\$2,590,917,656 (approximately RMB2.75 billion); and
- warranties given by CUCL to the A Share Company in relation to Guoxin Paging.

**Agreements relating to the Restructuring in connection with Acquisition of Unicom New Century from Unicom Group**

***The Reorganization Agreement***

In relation to the restructuring in connection with the acquisition by us of Unicom New Century from Unicom Group, Unicom Group entered into a reorganization agreement with Unicom New Century, dated November 18, 2002. This agreement includes the following terms:

- Unicom Group's agreement to transfer to Unicom New Century the assets and liabilities attributable to the businesses as described in A. History and Development of the Company- Acquisitions of Unicom New Century and Unicom New World and Sale of Guoxin Paging under Item 4;
- mutual warranties and indemnities given by Unicom Group and Unicom New Century in relation to the assets and liabilities transferred to Unicom New Century and in relation to the restructuring; and
- undertakings by Unicom Group in favor of Unicom New Century, including undertakings:
  - to hold and maintain all licenses received from the MII in connection with any of the transferred businesses for the benefit of Unicom New Century, and to allocate spectrum and to provide other resources to Unicom New Century;
  - subject to applicable Chinese laws and regulations in effect at the relevant time, to take all actions necessary to obtain, maintain, renew and otherwise extend to or for the benefit of Unicom New Century such governmental or regulatory licenses, consents, permits or other approvals as Unicom New Century may require to continue to operate its businesses; and
- not to engage in any business which competes with our businesses except for the existing competing businesses of Unicom Group.

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*Conditional Sale and Purchase Agreement*

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In relation to the acquisition by us of Unicom New Century from Unicom Group, we and Unicom BVI entered into a conditional sale and purchase agreement, dated November 20, 2002. This agreement includes the following terms:

- Unicom BVI's agreement to transfer all of its equity interest in Unicom New Century (BVI) Limited, which holds 100% of the equity interest in Unicom New Century, to us;
- our agreement to pay Unicom BVI a cash consideration in the amount of HK\$4,523,181,304 (approximately RMB4.8 billion); and
- warranties given by Unicom BVI to us in relation to Unicom New Century.

### **Agreements Relating to the Restructuring in Connection with Our Initial Public Offering**

#### *The Reorganization Agreement*

In relation to the restructuring in connection with our initial public offering, our wholly-owned subsidiary, CUCL, entered into a reorganization agreement with Unicom Group dated April 21, 2000. This agreement includes the following terms:

- Unicom Group's agreement to transfer to CUCL the assets and liabilities attributable to the businesses as described in A. History and Development of the Company – The Restructuring of Unicom Group and Our Initial Public Offering in 2000 under Item 4,
- mutual warranties and indemnities given by Unicom Group and CUCL in relation to the assets and liabilities transferred to CUCL and in relation to the restructuring,
- undertakings by Unicom Group in favor of CUCL, including, among others:
- to hold and maintain all licenses received from the MII in connection with any of our businesses for our benefit, and to allocate spectrum and to provide other resources to us;
- subject to applicable Chinese laws and regulations in effect at the relevant time, to take all actions necessary to obtain, maintain, renew and otherwise extend to or for our benefit such governmental or regulatory licenses, consents, permits or other approvals as we shall require to continue to operate our businesses;
- to arrange for us to participate in its international roaming arrangements;
- not to engage in any business which competes with our businesses except for the existing competing businesses of Unicom Group;
- to grant us a right of first refusal in relation to any government authorization, license or permit, or other business opportunity to develop any new telecommunications technology, product or service;
- to ensure that we can continue to use premises for which title documentation cannot be obtained at this time for a period of three years following the restructuring;

- not to dispose of any of our shares it beneficially owns or to take or permit any other actions, including primary issuances of securities by us or CUCL, which would result in us or CUCL no longer constituting majority owned subsidiaries of Unicom Group; and
- not to seek an overseas listing for any of its businesses or the businesses of its subsidiaries in which we are engaged or may engage in the future except through us,
- an option granted by Unicom Group to us to acquire Unicom Group's interest in any telecommunications interest such as Unicom Paging, Unicom Xingye and Unicom Group's CDMA telephony license and business, and
- a commitment by Unicom Group that it will provide continuous financial support to us when necessary.

#### ***Equity Transfer Agreement***

In relation to the restructuring in connection with our initial public offering, we, Unicom Group, China Unicom (Hong Kong) Group Limited and China Unicom (BVI) Limited entered into an equity transfer agreement, dated April 21, 2000. This agreement includes the following terms:

- Unicom Group's agreement to transfer all of its equity interest in CUCL to us;
- our agreement to issue shares to China Unicom (BVI) Limited, China Unicom (BVI) Limited's agreement to issue shares to China Unicom (Hong Kong) Group Limited and China Unicom (Hong Kong) Group Limited's agreement to issue shares to Unicom Group;
- Unicom Group's and our agreement that:
- we shall be entitled to apply in Hong Kong, Macau, Taiwan and in all places outside of China for all trademarks incorporating the word Unicom in English and Chinese and the Unicom logo; and
- once these trademarks have been registered, we will sublicense these trademarks to Unicom Group, CUCL, Guoxin Paging and Guoxin Paging's subsidiaries on a royalty-free basis; and
- warranties and indemnities given by Unicom Group to us in relation to CUCL.

#### ***Trademark Agreement***

Unicom Group is the registered owner of the Unicom trademark in English and the trademark bearing the Unicom logo, which are registered at the People's Republic of China State Trademark Bureau. Under a PRC trademark license agreement entered into on May 25, 2000 between Unicom Group and CUCL, CUCL and our affiliates were granted the right to use these trademarks on a royalty-free basis for an initial period of five years, renewable at the option of CUCL. Under the terms of this agreement, we and our affiliates are the exclusive licensees of these trademarks provided that Unicom Group may also license these trademarks to any of its existing or future subsidiaries. Unicom Group also agreed to license to CUCL any trademark that it registers in China in the future which incorporates the word Unicom.

CUCL entered into a service agreement with Unicom Paging on August 1, 2001. Under the terms of the agreement, both parties agreed to license their respective trademarks and logos to each other on equitable terms and free of charge.

**C. *Interests of Experts and Counsel***

Not applicable.

## Item 8. Financial Information

See Item 18, Financial Statements .

### Legal Proceedings

We are not involved in any material litigation, arbitration or administrative proceedings. So far as we are aware, we do not have any pending or threatened litigation, arbitration or administrative proceedings that is expected to have a material effect on our financial condition and results of operations.

### Policy on Dividend Distribution

The objective of our dividend policy is to achieve a long-term sustainable and steadily increasing dividend, with a view to maximize our shareholders' value. The declaration and payment of future dividends will depend upon, among other things, financial condition, business prospects, future earnings, cash flow, liquidity level and cost of capital. We believe such policy will provide our shareholders with a stable return in the long term along with the growth of our company. We may only pay dividends out of our distributable profits.

Having taken into account such factors as our financial condition, cash flow position and requirements to ensure the sustainable future growth of our business, our board of directors recommended payment of a final dividend of RMB0.11 per share for the financial year ended December 31, 2005. This represents an increase of 10.0% over the annual dividend of HK\$0.10 per share for the financial year ended December 31, 2004 and a dividend payout ratio of 28.1%.

## Item 9. The Offer and Listing

### Market Price Information

Our American depositary shares, each representing ten ordinary shares, are listed and traded on the New York Stock Exchange. Our ordinary shares are listed and traded on the Hong Kong Stock Exchange. The New York Stock Exchange and the Hong Kong Stock Exchange are the principal trading markets for our ADSs and ordinary shares, which are not listed on any other exchanges in or outside the United States.

The high and low closing prices of our ordinary shares on the Hong Kong Stock Exchange and of our ADSs on the New York Stock Exchange since listing are as follows:

|                      | Price per Ordinary Share (HK\$) |      | Price per ADS (US\$) |      |
|----------------------|---------------------------------|------|----------------------|------|
|                      | High                            | Low  | High                 | Low  |
| Annual:              |                                 |      |                      |      |
| 2001                 | 14.00                           | 7.10 | 18.00                | 9.00 |
| 2002                 | 8.90                            | 4.15 | 11.54                | 5.35 |
| 2003                 | 8.00                            | 3.92 | 10.55                | 5.02 |
| 2004                 | 10.20                           | 5.20 | 13.18                | 6.78 |
| 2005                 | 7.20                            | 5.65 | 9.19                 | 7.30 |
| Quarterly            |                                 |      |                      |      |
| First Quarter, 2004  | 10.20                           | 7.00 | 13.18                | 8.93 |
| Second Quarter, 2004 | 7.60                            | 5.20 | 9.55                 | 6.78 |
| Third Quarter, 2004  | 6.65                            | 5.55 | 8.53                 | 7.10 |



|                             | Price per Ordinary Share (HK\$) |      | Price per ADS (US\$) |      |
|-----------------------------|---------------------------------|------|----------------------|------|
|                             | High                            | Low  | High                 | Low  |
| Fourth Quarter, 2004        | 6.45                            | 5.50 | 8.28                 | 7.15 |
| First Quarter, 2005         | 7.20                            | 5.65 | 9.19                 | 7.30 |
| Second Quarter, 2005        | 6.65                            | 5.90 | 8.42                 | 7.61 |
| Third Quarter, 2005         | 6.95                            | 6.15 | 9.08                 | 7.83 |
| Fourth Quarter, 2005        | 6.65                            | 5.90 | 8.55                 | 7.54 |
| Monthly:                    |                                 |      |                      |      |
| January 2006                | 7.10                            | 6.30 | 9.13                 | 8.33 |
| February 2006               | 6.95                            | 6.20 | 8.89                 | 8.03 |
| March 2006                  | 6.75                            | 6.25 | 8.65                 | 8.05 |
| April 2006                  | 6.85                            | 6.45 | 8.90                 | 8.40 |
| May 2006                    | 7.75                            | 6.55 | 10.33                | 8.45 |
| June 2006 (through June 28) | 7.05                            | 6.40 | 8.95                 | 8.10 |

**Item 10. Additional Information**

**A. *Share Capital***

Not applicable.

**B. *Memorandum and Articles of Association***

**General**

Under our Memorandum of Association, we have the capacity, rights, powers, liabilities and privileges of a natural person. The following is a summary of selected provisions of our Articles of Association:

**Directors**

***Material Interests and Voting***

A director shall not vote (or be counted in the quorum) on any resolution of our board of directors in respect of any contract or arrangement or proposal in which he or any of his associates (as defined in the Hong Kong Stock Exchange Listing Rules) is, to his knowledge, materially interested, and if he shall do so, his vote shall not be counted (nor shall he be counted in the quorum for that resolution), but this prohibition does not apply to any contract, arrangement or other proposal for or concerning:

- the giving of any security or indemnity either (i) to the director or any of his associates (as defined in the Hong Kong Stock Exchange Listing Rules) in respect of money lent or obligations incurred by him or any of them at the request of or for the benefit of Unicom or any of its subsidiaries or (ii) to a third party in respect of a debt or obligation of Unicom or any of its subsidiaries for which the director or any of his associates has himself assumed responsibility or guaranteed or secured in whole or in part;
- an offer of shares or debentures or other securities of or by Unicom (or any other company which Unicom may promote or be interested in) where the director or any of his associates is a participant in the underwriting or sub-underwriting of the offer;

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- any other company in which the director or any of his associates is interested only, whether directly or indirectly, as an officer or shareholder or in which the director is beneficially interested in shares of that company, provided that he, together with any of his associates is not beneficially interested in 5% or more of (i) the issued shares of any class of such company (or of any third company through which such interest is derived) or (ii) the voting rights attached to such issued shares or securities (excluding for the purpose of calculating such 5% interest any indirect interest of such director or any of his associates by virtue of an interest of Unicom in such company);
- the benefit of employees of Unicom or any of its subsidiaries including (i) the adoption, modification or operation of any employees share scheme under which the director or any of his associates may benefit or (ii) the adoption, modification or operation of a pension fund or retirement, death or disability benefits scheme which relates both to directors, their associates and employees of Unicom or any of its subsidiaries and does not provide in respect of the director or any of his associates any privilege or advantage not generally accorded to the class of persons to which such scheme or fund relates; or
- any contract or arrangement in which the director or any of his associates is interested in the same manner as other holders of shares or debentures or other securities of Unicom by virtue only of his interest in shares or debentures or other securities of Unicom.

#### ***Remuneration and Pensions***

The directors of Unicom are entitled to receive by way of remuneration for their services such sum as is from time to time determined by Unicom in general meeting. The directors are also entitled to be repaid all traveling, hotel and other expenses reasonably incurred by them in or about the performance of their duties as directors. The board of directors may grant special remuneration to any director who performs services which in the opinion of the board are outside the scope of the ordinary duties of a director.

The board may establish and maintain any contributory or non-contributory pension or superannuation funds for the benefit of, or give donations, gratuities, pensions, allowances or emoluments to, any persons (i) who are or were at any time in the employment or service of Unicom, or of any company which is a subsidiary of Unicom, or is allied or associated with Unicom or with any such subsidiary company, or (ii) who are or were at any time directors or officers of Unicom or of any such other company above, and holding or who have held any salaried employment or office in Unicom or such other company, and the wives, widows, families and dependants of any such persons and may make payments for or towards the insurance of any such persons. Any director holding any such employment or office is entitled to participate in, and retain for his own benefit, any such donation, gratuity, pension, allowance or emolument.

#### ***Borrowing Powers***

The directors may exercise all the powers of Unicom to borrow money and to mortgage or charge all or any part of the undertaking, property and assets (present and future) and uncalled capital of Unicom and to issue debentures, debenture stocks, bonds and other securities, whether outright or as collateral security for any debt, liability or obligation of Unicom or of any third party.

#### ***Qualification of Directors***

A director of Unicom is not required to hold any qualification shares. No person is required to vacate office or be ineligible for re-election or reappointment as a director.

*Rotation of Directors*

At every annual general meeting, one-third of the directors for the time being, or, if the number is not three or a multiple of three, then the number nearest one-third, shall retire from office by rotation. The directors to retire in every year shall be those who have been longest in office since their last election. In addition, a director appointed by the board to fill in a casual vacancy or as an addition to the board shall retire at the next following general meeting and shall not be taken into account in determining the number of directors who are to retire by rotation at each annual general meeting. The retiring directors shall be eligible for re-election.

### **Rights Attached to Ordinary Shares**

#### ***Voting Rights***

Under the Companies Ordinance, any action to be taken by the shareholders in a general meeting requires the affirmative vote of either an ordinary or a special resolution passed at the meeting. An ordinary resolution is one passed by the majority of such shareholders as are entitled to, and do, vote in person or by proxy at a general meeting. A special resolution is one passed by not less than three-quarters of such shareholders as are entitled to, and do, vote in person or by proxy at a general meeting. Most shareholders decisions are passed by ordinary resolutions. However, the Companies Ordinance and our articles of association stipulate that certain matters may only be passed by special resolutions.

Subject to any special rights, privileges or restrictions as to voting that may from time to time be attached to any class or classes of shares, at any general meeting a resolution put to the vote of the meeting shall be decided on a show of hands unless a poll is required by the Listing Rules of the Hong Kong Stock Exchange or is demanded by:

- the chairman of the meeting,
- at least three shareholders present in person or by proxy and entitled to vote at the meeting,
- any shareholder or shareholders present in person or by proxy and representing in the aggregate not less than one-tenth of the total voting rights of all shareholders having the right to attend and vote at the meeting, or
- any shareholder or shareholders present in person or by proxy and holding shares conferring a right to attend and vote at the meeting on which there have been paid up sums in the aggregate equal to not less than one-tenth of the total sum paid up on all shares conferring that right.

On a show of hands, every individual shareholder who is present in person and every corporate shareholder who is present by a representative duly authorized under section 115 of the Companies Ordinance has one vote.

On a poll, every shareholder present in person or, if the shareholder is a corporation, by duly authorized representative, or by proxy has one vote for every share of which he or she is the shareholder which is fully paid up or credited as fully paid up. However, no amount paid up or credited as paid up on a share in advance of calls or installments is treated for the foregoing purposes as paid up on the share.

Any action to be taken by the shareholders requires the affirmative vote of a majority of the shares at a meeting of shareholders. There are no cumulative voting rights. Accordingly, the holders of a majority of the shares voting for the election of directors can elect all the directors if they choose to do so.

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***Issue of Shares***

Under the Companies Ordinance, our board of directors may, without prior approval of our shareholders, offer to issue new shares to existing shareholders proportionately according to their shareholdings. Our board of directors may not offer to issue new shares in any other manner without the prior approval of our shareholders in a general meeting. Any such approval given in a general meeting will continue in force until the conclusion of the following annual general meeting or the expiration of the period within which the next annual general meeting is required by law to be held or when revoked or varied by an ordinary resolution of our shareholders in a general meeting, whichever comes first. If such approval is given, the unissued shares shall be at the disposal of our board of directors, which may offer, allot, grant options over or otherwise dispose of them to such persons, at such times and for such consideration and upon such terms and conditions as our board of directors may determine.

In accordance with the Listing Rules of the Hong Kong Stock Exchange, any such approval given by the shareholders must be limited to shares with an aggregate nominal value not exceeding 20 per cent of the aggregate nominal value of our share capital in issue plus the aggregate nominal amount of share capital repurchased by us since the granting of such approval.

***Dividends***

Subject to the Companies Ordinance and as set out in our articles of association, our shareholders in a general meeting may from time to time by ordinary resolution declare dividends to be paid to our shareholders according to their rights and interests in the profits available for distribution, but no dividend shall be declared in excess of the amount recommended by our board of directors.

In addition to any dividends declared in a general meeting upon the recommendation of the board of directors, our board of directors may from time to time declare and pay to our shareholders such interim dividends as appear to our board of directors to be justified by our financial position. Our board of directors may also pay any fixed dividend which is payable on any of our shares on any other dates, whenever our financial position, in the opinion of our board of directors, justifies such payments.

All dividends or bonuses unclaimed for one year after having become payable may be invested or otherwise made use of by the board for the benefit of Unicom until claimed. All dividends or bonuses unclaimed for six years after having been declared may be forfeited by the board and will revert to Unicom.

***Winding Up***

If we are wound up, the surplus assets remaining after payment to all creditors shall be divided among the shareholders in proportion to the capital paid up on the shares held by them, subject to the rights of the holders of any shares which may be issued on special terms or conditions.

If we are wound up, the liquidator may, with the sanction of a special resolution, divide among our shareholders in specie or in kind the whole or any part of our assets or vest any part of our assets in trustees upon such trusts for the benefit of our shareholders or any of them as the resolution shall provide.

***Miscellaneous***

Shareholders are not entitled to any redemption rights, conversion rights or preemptive rights on the transfer of ordinary shares.

The transfer agent and registrar for the shares is Hong Kong Registrars Limited, 46th Floor, Hopewell Centre, 183 Queen's Road East, Hong Kong.

### ***Modification of Rights***

Subject to the Companies Ordinance, any of the rights from time to time attaching to any class of shares may, subject to the provisions of the Companies Ordinance, be varied or abrogated with the consent in writing of the holders of not less than three-fourths of the issued shares of that class or with the sanction of a special resolution passed at a separate general meeting of the holders of shares of that class. The provisions of our Articles of Association relating to general meetings apply to such separate general meetings, except that the necessary quorum is not less than two persons holding or representing by proxy one-third in nominal value of the issued shares of that class, and that any holder of the shares of the class present in person or by proxy may demand a poll.

### **Annual General and Extraordinary General Meetings**

We must hold in each year a general meeting as our annual general meeting in addition to any other meetings in that year. The annual general meeting is held at such time (within a period of not more than fifteen months, or such longer period as the Registrar of Companies of Hong Kong may authorize in writing, after the holding of the last preceding annual general meeting) and place as may be determined by the Directors. All other general meetings are called extraordinary general meetings. The Directors may call an extraordinary general meeting at any time or upon request in accordance with the Hong Kong Companies Ordinance.

Subject to the Companies Ordinance, an annual general meeting and a meeting called for the passing of a special resolution can be called by not less than twenty-one days' notice in writing, and any other general meeting can be called by not less than fourteen days' notice in writing. The notice must specify the place, date and time of meeting, and, in the case of special business, the general nature of that business.

### **Limitations on Rights to Own Securities**

There are no limitations on the rights to own securities, including the rights of non-resident or foreign shareholders to hold or exercise voting rights on the securities, imposed by Hong Kong law or by our Memorandum of Association or our Articles of Association.

### **Changes in Capital**

We may exercise any powers conferred or permitted by the Companies Ordinance to purchase or otherwise acquire our own shares and warrants at any price or to give, directly or indirectly, by means of a loan, guarantee, the provision of security or otherwise, financial assistance for the purpose of or in connection with a purchase made by any person of any shares or warrants in Unicom. Repurchases of our own shares may be made either by way of a general offer to all shareholders in proportion to their shareholdings, by purchasing our shares on a stock exchange or by an off-market contract with individual shareholders. Any such purchase or other acquisition or financial assistance must be made or given in accordance with any relevant rules or regulations issued by the Hong Kong Stock Exchange or the Securities and Futures Commission of Hong Kong.

We in general meeting may, from time to time, by ordinary resolution increase our authorized share capital by the creation of new shares, and prescribe the amount of new capital and number of new shares. We may from time to time by ordinary resolution:

- consolidate and divide all or any of our share capital into shares of a larger amount than our existing shares;
- divide our shares into several classes and attach to them any preferential, deferred, qualified or special rights, privileges or conditions;

- cancel any shares which at the date of the passing of the resolution have not been taken or agreed to be taken by any person, and diminish the amount of our share capital by the amount of the shares so canceled;
- sub-divide our shares or any of them into shares of a smaller amount than is fixed by our Memorandum of Association, subject nevertheless to the provisions of the Companies Ordinance; and
- make provision for the issue and allotment of shares which do not carry any voting rights.

**C. *Material Contracts***

In addition to contracts we have entered into with our controlling shareholder, Unicom Group, or its subsidiaries, as described in Related Party Transactions under Item 7, Unicom Group, we or our subsidiaries have entered into the following contracts that are not in the ordinary course of business within the two years preceding the date of this annual report that are or may be material:

- Conditional Sale and Purchase Agreement between China Unicom (Hong Kong) Group Limited and our Company, dated July 28, 2004, relating to our acquisition of Unicom International. See A. History and Development of the Company Acquisition of China Unicom International Limited under Item 4.

**D. *Exchange Controls***

The ability of our operating subsidiaries, CUCL and Unicom New World, to satisfy their respective foreign exchange obligations and to pay dividends to us depends on existing and future exchange control regulations in China. The Renminbi is currently convertible under the current account, which includes trade and service related foreign exchange transactions. Renminbi currently cannot be converted under the capital account, which includes foreign direct investment. CUCL and Unicom New World, our wholly-owned subsidiaries that hold substantially all of our assets, are both foreign investment enterprises. The foreign investment enterprise status will allow these subsidiaries to purchase foreign exchange at designated foreign exchange banks for settlement of current account transactions without the approval of the State Administration for Foreign Exchange. These current account transactions include payment of dividends. However, the relevant PRC government authorities may in the future limit or eliminate the authorizations for a foreign investment enterprise to retain its foreign exchange to satisfy its foreign exchange obligations or to pay dividends in the future. Furthermore, certain foreign exchange transactions of these subsidiaries under the capital account still require approvals from the State Administration for Foreign Exchange. This requirement affects our subsidiaries' ability to obtain foreign exchange through equity financing, including by means of capital contributions from us.

Under existing Hong Kong law, (i) there are no foreign exchange controls or other laws which restrict the import or export of capital and which would affect the availability of cash and cash equivalents for our use, (ii) there are no foreign exchange controls or other laws, decrees or regulations that affect the remittance of interest, dividends or other payments on our outstanding debt and equity securities to U.S. residents and (iii) there are no limitations on the rights of non-resident or foreign owners to hold our debt or equity securities.



**E. Taxation**

The taxation of income and capital gains of holders of ordinary shares or ADSs is subject to the laws and practices of Hong Kong and of jurisdictions in which holders of ordinary 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 ordinary shares or ADSs. In particular, the discussion does not address the tax consequences under state, local and other laws, such as non-Hong Kong and non-U.S. federal laws. The discussion is based upon laws and relevant interpretations in effect as of the date of this annual report.

**Hong Kong**

***Tax on Dividends***

Under the current practices of the Hong Kong Inland Revenue Department, no tax is payable in Hong Kong in connection with dividends paid by us, either by withholding or otherwise, unless such dividends are attributable to a trade, profession or business carried on in Hong Kong.

***Profits***

No tax is imposed in Hong Kong in respect of capital gains from the sale of shares and ADSs. Trading gains from the sale of shares or ADSs 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 income tax rates of 17.5% on corporations and 16.0% on individuals. Gains from sales of shares effected on the Hong Kong Stock Exchange will be considered to be derived from or arise in Hong Kong. Liability for Hong Kong income tax would thus arise in respect of trading gains from sales of shares or ADSs realized by persons carrying on a business of trading or dealing in securities in Hong Kong.

***Stamp Duty***

Hong Kong stamp duty, currently charged at the rate of 0.1% of the higher of the consideration for or the value of the shares, will be payable by the purchaser on every purchase and by the seller on every sale of 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 shares upon the surrender of ADRs, and the issuance of ADRs upon the deposit of shares, will also attract stamp duty at the rate described above unless such withdrawal or deposit does not result in a change in the beneficial ownership of the shares under Hong Kong law. The issuance of the ADRs upon the deposit of shares issued directly to The Bank of New York, as depositary of the ADSs, or for the account of The Bank of New York does not attract stamp duty. No Hong Kong stamp duty is payable upon the transfer of ADSs outside Hong Kong.

***Estate Duty***

The Revenue (Abolition of Estate Duty) Ordinance 2005 became effective on February 11, 2006 in Hong Kong. No Hong Kong estate duty is payable and no estate duty clearance papers are needed for an application for a grant of representation in respect of holder of the shares, whose deaths occur on or after February 11, 2006.

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## United States

### *United States Federal Income Taxation*

This section describes the material United States federal income tax consequences to a U.S. holder (as defined below) of owning shares or ADSs. It applies to you only if you hold your shares or ADSs as capital assets for 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 dealer in securities,
- a trader in securities that elects to use a mark-to-market method of accounting for your securities holdings,
- a tax-exempt organization,
- 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 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 person 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 Depository 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 shares or ADSs and you are:

- a citizen or resident of the United States,
- a corporation organized under the laws of the United States or any States,
- 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 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 the shares represented by those ADSs. Exchanges of shares for ADSs, and ADSs for 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, the gross amount of any dividend we pay out of our current or accumulated earnings and profits (as determined for United States federal income tax purposes) is subject to United States federal taxation. If you are a non-corporate U.S. holder, dividends paid to you in taxable years beginning after December 31, 2002 and before January 1, 2011 that constitute qualified dividend income will be taxable to you at a maximum tax rate of 15% provided that you hold the 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 the shares or ADSs will be qualified dividend income provided that, in the year that you receive the dividend, the shares or ADSs are readily tradable on an established securities market in the United States.

The dividend is taxable to you when you, in the case of shares, or the Depositary, 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. 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 spot Hong Kong/U.S. dollar 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 and will not be eligible for the special tax rate applicable to qualified dividend income. The gain or loss generally will be income or loss 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 shares or ADSs and thereafter as capital gain.

Special rules apply in determining the foreign tax credit limitation with respect to dividends that are subject to the maximum 15% tax rate. 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 passive foreign investment company rules discussed below, if you are a U.S. holder and you sell or otherwise dispose of your 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 shares or ADSs. Capital gain of a non-corporate U.S. holder that is recognized on or after May 6, 2003 and before January 1, 2011 is generally taxed at a maximum rate of 15% where the property is held more 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. 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.

***Passive Foreign Investment Company Rules.*** We believe that we should not be treated as a passive foreign investment company 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.

In general, if you are a U.S. holder, we will be a passive foreign investment company with respect to you if for any taxable year in which you held our ADSs or shares:

- at least 75% of our gross income for the taxable year is passive income, or
- at least 50% of the value, determined on the basis of a quarterly average, of our assets is attributable to assets that produce or are held for the production of passive income.

Passive income generally includes dividends, interest, royalties, and rents, but not including certain rents and royalties derived in the active conduct of a trade or business, annuities, gains from assets that produce passive income. If a foreign corporation owns directly or indirectly at least 25% by value of the stock of another corporation, the foreign corporation is treated for purposes of the passive foreign investment company tests as owning its proportionate share of the assets of the other corporation, and as receiving directly its proportionate share of the other corporation's income.

If we are treated as a passive foreign investment company, and you are a U.S. holder that does not make a mark-to-market election, as described below, you will be subject to special rules with respect to:

- any gain you realize on the sale or other disposition of your shares or ADSs, and
- any excess distribution that we make to you. Generally, any distributions to you during a single taxable year that are greater than 125% of the average annual distributions received by you in respect of the shares or ADSs during the three preceding taxable years or, if shorter, your holding period for the shares or ADSs.

Under these rules:

- the gain or excess distribution will be allocated ratably over your holding period for the shares or ADSs,
- the amount allocated to the taxable year in which you realized the gain or excess distribution will be taxed as ordinary income,
- the amount allocated to each prior year, with certain exceptions, will be taxed at the highest tax rate in effect for that year, and
- the interest charge generally applicable to underpayments of tax will be imposed in respect of the tax attributable to each such year.

Special rules apply for calculating the amount of the foreign tax credit with respect to excess distributions by a passive foreign investment company.

If you own shares or ADSs in a passive foreign investment company that are treated as marketable stock, you may make a mark-to-market election. If you make this election, you will not be subject to the passive foreign investment company rules described above. Instead, in general, you will include as ordinary income each year the excess, if any, of the fair market value of your shares or ADSs at the end of the taxable year over your adjusted basis in your shares or ADSs. You will also be allowed to take an ordinary loss in respect of the excess, if any, of the adjusted basis of your shares or ADSs over their fair market value at the end of the taxable year (but only to the extent of the net amount of previously included income as a result of the mark-to-market election). Your basis in the shares or ADSs will be adjusted to reflect any such income or loss amounts. Your gain, if any, recognized upon the sale of your shares or ADSs will be taxed as ordinary income.

In addition, notwithstanding any election you make with regard to the shares or ADSs, dividends that you receive from us will not constitute qualified dividend income to you if we are a PFIC either in the taxable year of the distribution or the preceding taxable year. Dividends that you receive that do not constitute qualified dividend income are not eligible for taxation at the 15% maximum rate applicable to qualified dividend income. Instead, you must include the gross amount of any such dividend paid by us out of our accumulated earnings and profits (as determined for United States federal income tax purposes) in your gross income, and it will be subject to tax at rates applicable to ordinary income.

If you own shares or ADSs during any year that we are a passive foreign investment company, you must file Internal Revenue Service Form 8621.

**F. Dividends and Paying Agents**

Not applicable.

**G. Statement by Experts**

Not applicable.

**H. Documents on Display**

You can read and copy documents referred to in this annual report that have been filed with the U.S. Securities and Exchange Commission, or the SEC, at the SEC's public reference room located at 100 F Street, N.E., Room 1580, 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.

**Item 11. Quantitative and Qualitative Disclosures About Market Risks**

Our exposure to financial market risks relates primarily to changes in interest rates and currency exchange rates.

**Interest Rate Risk**

We are subject to market risks due to fluctuations in interest rates, principally as a result of our long-term loans, all of which bear variable interest rates. The original maturities of our long-term loans range from one to five years.

The People's Bank of China has the sole authority in China to establish 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. The fair value of our borrowings is the same as the carrying value since all our bank loan interest are variable. Most of our bank loans are denominated in Renminbi and borrowed from domestic banks at interest rates that vary in accordance with the standard guidance interest rates announced by relevant PRC government authorities.

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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. In September 2003, we entered into a US\$700 million term loan facility with 13 financial institutions, which is consisted of three tranches: a three-year US\$200 million tranche, with an interest rate of 0.28% over the US\$ LIBOR, a five-year US\$300 million tranche, with an interest rate of 0.35% over the US\$ LIBOR, and a seven-year US\$200 million tranche, with an interest rate of 0.44% per annum over the US\$ LIBOR.

In February 2004, we entered into a US\$500 million long-term syndicated loan agreement with 12 financial institutions to finance working capital and network construction expenditure. This facility is repayable in three years and carries an interest rate of 0.40% over US\$ LIBOR per annum.

In July 2005, CUCL completed an offering of two tranches of short-term bonds in the PRC interbank debenture market. The first tranche of the bonds was issued for an aggregate amount of RMB9.0 billion with a maturity period of 365 days. The second tranche of the bonds was issued for an aggregate amount of RMB1.0 billion with a maturity period of 180 days. The effective interest rate as at December 31, 2005 was 2.89%. As a result, our fixed rate debt obligation as of December 31, 2005 was RMB9.87 billion.

As a result, we are exposed to interest rate risk resulting from fluctuations in interest rates on our debts. Increases in interest rates will increase the cost of new borrowing and the interest expense with respect to our outstanding floating rate debt, and therefore could have a material adverse effect on our financial position. From time to time, we may enter into interest rate swap agreements designed to mitigate our exposure to interest rate risks in connection with our borrowings denominated in foreign currencies, although we did not consider it necessary to do so in 2005. We are also considering hedging our borrowings denominated in Renminbi once interest rate swaps become available for Renminbi-denominated borrowings in China.

The following table provides information, by maturity date, regarding our interest rate-sensitive financial instruments, which consist of variable rate debt obligation, as of December 31, 2005.

|                                    | Expected Maturity Date                            |   |       |   |       |   |      |   |       |   | As of December 31, 2005 |        |            |
|------------------------------------|---|---|-------|---|-------|---|------|---|-------|---|-------------------------|--------|------------|
|                                    | 2006  |   | 2007  |   | 2008  |   | 2009 |   | 2010  |   | Thereafter              | Total  | Fair Value |
|                                    | (RMB equivalent in million, except interest rate) |   |       |   |       |   |      |   |       |   |                         |        |            |
| Variable rate bank and other loans | 12,170  |   | 6,138 |   | 3,502 |   | 553  |   | 1,788 |   |                         | 24,151 | 24,151     |
| Average interest rate(1)           | 5.64  | % | 4.86  | % | 4.83  | % | 4.83 | % | 4.80  | % |                         |        |            |

(1) The interest rates for variable rate bank and other loans are calculated based on the weighted average interest rates at the end of 2005.

For the year ended December 31, 2005, if the average interest rates for our variable rate bank and other loans had increased by 10%, we estimate that we would have incurred additional interest expenses of RMB178 million in 2005.

#### Exchange Rate Risk

The majority of our indebtedness and capital expenditures are in Renminbi. Currency exchange rate risk exists with respect to our repayment of indebtedness to our foreign lenders, payables to equipment suppliers and contractors and our dividend payments to holders of ordinary shares and ADSs in foreign currencies. As of December 31, 2005, we had approximately RMB0.2 billion of capital commitments in currencies other than Renminbi. We also had foreign currency-denominated debt outstanding, representing our three-tranche US\$700 million term loan entered into with 13 financial institutions in September 2003 and \$500 million long-term syndicated loan entered into with 12 financial institutions in February 2004 as described above. In addition, we had approximately US\$118 million in bank balances and cash, and short-term bank deposits as of December 31, 2005. Fluctuations in exchange rates may lead to significant fluctuations in the exposure of our foreign-currency-denominated liabilities and assets. We may, from time to time, enter into currency swap agreements and foreign exchange forward contracts designed to mitigate our exposure to foreign currency risks, although we did not consider this to be necessary in 2005. Although the Renminbi to US dollar exchange rate has been relatively stable since 1994, we cannot predict nor give any assurance of its future stability. On July 21, 2005, the PRC government changed its decade-old policy of pegging the value of the Renminbi to the U.S. dollar. As a result of the revaluation of the Renminbi, we recorded a foreign exchange gain of RMB0.27 billion.

The following table provides information regarding our foreign currency-sensitive financial instruments and transactions, which consist of short-term bank deposits, bank balances and cash, long-term debt obligations and capital commitments as of December 31, 2005.

|  | Expected Maturity Date |       |       |      |       |            | As of December 31, 2005 |            |
|--|------------------------|-------|-------|------|-------|------------|-------------------------|------------|
|  | 2006                   | 2007  | 2008  | 2009 | 2010  | Thereafter | Total                   | Fair Value |
| (RMB equivalent in million, except interest rate)                |                        |       |       |      |       |            |                         |            |
| <b>On-balance sheet financial instruments:</b>                   |                        |       |       |      |       |            |                         |            |
| Short-term deposits with banks:                                  |                        |       |       |      |       |            |                         |            |
| in U.S. dollars  | 282                    |       |       |      |       |            | 282                     | 282        |
| in Hong Kong dollars   |                        |       |       |      |       |            |                         |            |
| Bank balances and cash:  |                        |       |       |      |       |            |                         |            |
| in U.S. dollars  | 670                    |       |       |      |       |            | 670                     | 670        |
| in Hong Kong dollars   | 48                     |       |       |      |       |            | 48                      | 48         |
| in MOP   | 0.09                   |       |       |      |       |            | 0.09                    | 0.09       |
| in EUR   | 0.86                   |       |       |      |       |            | 0.86                    | 0.86       |
| <b>Debts:</b>  |                        |       |       |      |       |            |                         |            |
| Variable rate bank and other loans (U.S. dollar)                 | 1,614                  | 4,035 | 2,421 |      | 1,614 |            | 9,684                   | 9,684      |
| Average interest rate <sup>(1)</sup>                             | 4.82                   | %     | 4.79  | %    | 4.83  | %          | 4.90                    | %          |
| <b>Off-balance sheet commitments:</b>                            |                        |       |       |      |       |            |                         |            |
| Capital commitments authorized and contracted for in U.S. dollar | 218                    |       |       |      |       |            | 218                     | 218        |

(1) The interest rates for variable rate bank and other loans are calculated based on the weighted average interest rates at the end of 2005.

## 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**

None.

**Item 15. Controls and Procedures**

**(a) Evaluation of Disclosure Controls and Procedures**

Our chief executive officer and chief financial officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the Exchange Act of 1934, as amended) as of December 31, 2005, the end of the period covered by this annual report, and taking into consideration the measures discussed below, have concluded that, as of such date, our disclosure controls and procedures were effective to ensure that material information relating to our Company was made known to them by others within our Company.

**(d) Changes in Internal Control Over Financial Reporting**

Except as stated below, there were no changes in our internal control over financial reporting that occurred during the period covered by this annual report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

We are fully aware of the importance of maintaining and improving our controls and procedures in relation to internal control over financial reporting. As disclosed in our annual report on Form 20-F for the year ended December 31, 2004, we have identified a material weakness due to certain improper accounting recordings and errors at our Jiangxi and Xinjiang branches during our regular internal audit in 2004 and adopted various measures to prevent a recurrence of such incidents and to improve our internal control over financial reporting. Acting under the supervision and guidance of our audit committee and board of directors, our management worked to address the identified material weakness. In 2005, we have implemented a series of measures to strengthen control processes and procedures and improve our internal control over financial reporting. These measures include, among others:

- formulating internal audit standards to further clarify the processes and procedures of internal audit;
- upgrading the accounting information technology system, developing and testing the consolidated financial reporting system;
- establishing the procedures for regulating the financial reporting at our branches;
- continuing to improve the policies and standards for the control environment within The Committee of Sponsoring Organizations of the Treadway Commission risk control framework;
- engaging external consultants to advise on internal control in respect of our information technology system; and
- formulating company-wide anti-fraud policies and establishing enhanced anti-fraud and whistle-blowing mechanism.

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While we have adopted a series of measures aiming at improving our internal control over financial reporting during 2005, our assessment of the progress made for the period relevant for the preparation of our consolidated financial statements as of and for the year ended December 31, 2005 has revealed that there remains significant control deficiencies relating to: (i) the sufficiency of monitoring controls over period-end financial closing procedures of certain individual branches and (ii) the sufficiency of advanced knowledge, experiences and skills of our accounting personnel when applying international accounting standards.

Our management, with the oversight of our audit committee and board of directors, is committed to having proper internal control over financial reporting. We believe that the measures already being implemented will continue to improve our internal control over financial reporting since many of these measures relate to people and processes that require time before they are fully effective. With regard to the significant control deficiencies discussed above, we have implemented improved control procedures for regulating the financial reporting at the branch level and hired accounting professionals with experience in financial reporting and familiarity with international accounting practices. We believe that our internal control procedures have an adequate design quality, and we will implement further personnel training and increased supervision to remediate deficiencies in the operation of the procedures.

Section 404 of the Sarbanes-Oxley Act of 2002 will require us to include an internal control report of management with our annual report on Form 20-F for the fiscal year ending December 31, 2006. Since 2005, in preparation for compliance with Section 404 of the Sarbanes-Oxley Act of 2002 and under the supervision and with the participation of our senior management, including our chief executive officer and chief financial officer, we have been conducting further evaluation of our internal control over financial reporting and designing and implementing enhanced processes and controls to improve our internal control over financial reporting. We are still in the detailed evaluation process and as we implement enhanced processes and controls, and we may identify additional conditions that may result in significant control deficiencies or material weakness in the future. Should we discover such conditions, we will take appropriate actions for correction or improvement.

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

Our board of directors has determined that Mr. Wong Wai Ming, an Independent Non-executive Director and a member of our audit committee, is an audit committee financial expert.

#### **Item 16B. Code of Ethics**

In 2003, we adopted a code of ethics that applies to our chief executive officer, chief financial officer, president, vice-presidents, controller and other senior officers. A copy of our Code of Ethics for Senior Officers was filed as Exhibit 11.1 to our annual report on Form 20-F for the fiscal year ended December 31, 2003. In February 2006, we adopted another code of ethics that applies to our employees generally. A copy of our Code of Ethics for Employees is filed as Exhibit 11.2 to this annual report on Form 20-F for the fiscal year ended December 31, 2005. Copies of our Code of Ethics for Senior Officers and Code of Ethics for Employees may also be downloaded from our website at <http://www.chinaunicom.com.hk>. Information on that website is not a part of this annual report on Form 20-F.

**Item 16C. Principal Accountant Fees and Services**

The following table sets forth the aggregate audit fees, audit-related fees, tax fees and other fees for our principal accountant billed for products and services provided by our principal accountant for audit services, audit-related services, tax services and other services for each of the fiscal years 2003, 2004 and 2005:

|                    | For the years ended<br>December 31, |                  |                   |
|--------------------|-------------------------------------|------------------|-------------------|
|                    | 2003                                | 2004             | 2005              |
|                    | (in US dollars)                     |                  |                   |
| Audit fees         | 6,528,000                           | 6,950,000        | 7,350,000         |
| Audit-related fees | 1,900,000                           | 10,000           | 3,704,800         |
| Tax fees           | 2,000                               | 14,000           | 4,300             |
| All other fees     |                                     | 190,000          |                   |
| <b>Total</b>       | <b>8,430,000</b>                    | <b>7,164,000</b> | <b>11,059,100</b> |

Audit services are defined as the standard audit work that needs to be performed each year in order to issue an opinion on the consolidated financial statements of our Company and its subsidiaries. It also includes audit services that only the external auditor reasonably can provide, such as pre-issuance reviews of quarterly and interim financial results.

Audit-related services include other assurance and related services that can be reasonably provided by the external auditor signing the audit report. These audit-related services are reasonably related to the performance of the audit or review of the financial statements of the Company and its subsidiaries such as acquisition audit, special audit for the issuance of short-term bonds, agreed-upon procedures on certain transactions, consultations concerning financial accounting and reporting standards and advisory services in relation to internal control over financial reporting.

Tax services include the assistance with compliance and reporting of enterprise taxes, assistance with our assessment of new or changing tax regimes, and assistance with assessing relevant rules, regulations and facts going into our correspondence with tax authorities.

Other services include review of revenue assurance process provided by our principal accountant to our provincial branch in 2004.

**Audit Committee's Pre-approval Policies and Procedures**

The Audit Committee of our Board of Directors is responsible, among other things, for the oversight of the external auditor subject to the requirements of the Hong Kong Company Ordinance and our Articles of Association. The Audit Committee has adopted a policy regarding pre-approval of audit and permissible non-audit services to be provided by our independent accountants. Under the policy, proposed services either (i) may be pre-approved by the Audit Committee without consideration of specific case-by-case services; or (ii) require the specific pre-approval of the Audit Committee. General approval applies to services of a recurring and predictable nature. These types of services, once approved by the Audit Committee, will not require further approval in the future, except when actual fees and expenses exceed pre-approved budget levels. In such a case, the Audit Committee may authorize one of its members to approve budget increases subject to the requirement that such member provide a report on his decision to approve or deny an application for budget increases to the Audit Committee at an Audit Committee meeting held immediately after such member grants or denies the approval.

Specific pre-approval applies to all other services. These services must be approved by the Audit Committee on a case-by-case basis after an application including proposed budget and scope of services to be provided by our independent auditors is submitted to the Audit Committee.

**Item 16D. Exemptions from the Listing Standards for Audit Committees**

Not applicable.

**Item 16E. Purchases of Equity Securities by the Issuer and Affiliated Purchasers**

Not applicable.

**PART III**

**Item 17. Financial Statements**

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

**Item 18. Financial Statements**

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

**Item 19. Exhibits**

**Exhibit**

| <b>Number</b> | <b>Description of Exhibit</b>   |
|---------------|---|
| 1.1           | Memorandum of Association of Unicom, dated January 27, 2000(1).   |
| 1.2           | Amended Articles of Association of Unicom (as amended)(1).  |
| 1.3           | Amended Articles of Association of Unicom (as amended on May 12, 2004)(6).  |
| 2.1           | Deposit Agreement, among Unicom, the Bank of New York, as Depository, and Owners and Beneficial Owners of American Depositary Receipts issued thereunder, including the form of American Depositary Receipt(2). |
| 2.2           | Form of specimen certificate for the shares(1).   |
| 4.1           | CDMA Network Capacity Lease Agreement among CUCL, Unicom Group and Unicom New Horizon, dated November 22, 2001(4).  |
| 4.2           | Reorganization Agreement between Unicom Group and CUCL (together with English translation)(1).  |
| 4.3           | Services Agreement between Unicom Group and CUCL (together with English translation)(1).  |
| 4.4           | Lease Agreement between CUCL and Unicom Xingye Science and Technology Trade Co. Ltd. (together with English translation)(1).  |
| 4.5           | Transmission Line Lease and Services Agreement between Unicom Group, CUCL and Guoxin Paging (together with English translation)(1).   |
| 4.6           | Pre-Global Offering Share Option Scheme, adopted by ordinary resolution of the Company on June 1, 2000 and amended by ordinary resolution of the Company on May 13, 2002(4).                                    |
| 4.7           | Share Option Scheme, adopted by ordinary resolution of the Company on June 1, 2000 and amended by ordinary resolution of the Company on May 13, 2002(4).  |

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- 4.8 Service Agreements between executive directors of Unicom and Unicom(3).
- 4.9 Reorganization Agreement between Unicom Group and Unicom New Century, dated November 18, 2002. (English translation)(5).
- 4.10 Form of Conditional Sale and Purchase Agreement between Unicom BVI and our company, dated November 20, 2002(5).

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| Exhibit Number | Description of Exhibit  |
|----------------|---|
| 4.11           | Comprehensive Services Agreement between Unicom Group and A Share Company, dated November 20, 2002. (English translation)(5).   |
| 4.12           | Transfer Agreement with respect to the Comprehensive Services Agreement between A Share Company and Unicom New Century, dated November 20, 2002. (English translation)(5).                                  |
| 4.13           | Form of CDMA Network Capacity Lease Agreement among Unicom New Horizon, A Share Company and Unicom Group, dated November 20, 2002(5).   |
| 4.14           | Transfer Agreement with respect to the CDMA Network Capacity Lease Agreement between A Share Company and Unicom New Century, dated November 20, 2002. (English translation)(5).                             |
| 4.15           | Reorganization Agreement between Unicom Group and Unicom New World, dated November 4, 2003. (English translation)(6).   |
| 4.16           | Conditional Sale and Purchase Agreement between Unicom BVI and our Company, dated November 20, 2003(6).   |
| 4.17           | Conditional Sale and Purchase Agreement between CUCL and A Share Company, dated November 20, 2003. (English translation)(6).  |
| 4.18           | Comprehensive Services Agreement between Unicom Group and A Share Company, dated November 20, 2003. (English translation)(6).   |
| 4.19           | Transfer Agreement with respect to the Comprehensive Services Agreement between A Share Company and Unicom New World, dated November 20, 2003. (English translation)(6).                                    |
| 4.20           | CDMA Network Capacity Lease Agreement among Unicom New Horizon, A Share Company and Unicom Group, dated November 20, 2003(6).   |
| 4.21           | Transfer Agreement with respect to the CDMA Network Capacity Lease Agreement between A Share Company and Unicom New World, dated November 20, 2003. (English translation)(6).                               |
| 4.22           | Comprehensive Operator Services Agreement between Unicom Group and A Share Company, dated November 20, 2003. (English translation)(6).  |
| 4.23           | Transfer Agreement with respect to the Comprehensive Operator Services Agreement between A Share Company, CUCL, Unicom New Century and Unicom New World, dated November 20, 2003. (English translation)(6). |
| 4.24           | Service Agreement between Mr. William Lo Wing Yan, executive director of Unicom, and Unicom. (English translation)(6).  |
| 4.25           | Letter Agreement between Mr. Wang Jianzhou, executive director of Unicom, and Unicom with respect to the Extension of the Service Agreement between Mr. Wang and Unicom. (English translation)(6).          |
| 4.26           | Conditional Sales and Purchase Agreement between China Unicom (Hong Kong) Group Limited and our Company with respect to the acquisition of Unicom International, dated July 28, 2004(7).                    |
| 4.27           | CDMA Network Capacity Lease Agreement between Unicom New Horizon, A Share Company and Unicom Group, dated March 24, 2005(7).  |
| 4.28           | Transfer Agreement of The CDMA Network Capacity Lease Agreement between A Share Company, CUCL and Unicom New World, dated March 24, 2005. (English translation)(7).   |

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- 4.29 Comprehensive Services Agreement between A Share Company and Unicom Group, dated March 24, 2005. (English translation) (7).
- 4.30 Transfer Agreement of the Comprehensive Services Agreement between A Share Company, CUCL and Unicom New World, dated March 24, 2005. (English translation) (7).

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| Exhibit Number | Description of Exhibit  |
|----------------|---|
| 4.31           | Operator-based Comprehensive Services Agreement between Unicom New Guoxin and A Share Company, dated March 24, 2005. (English translation) (7).                                   |
| 4.32           | Transfer Agreement of the Operator-based Comprehensive Services Agreement between A Share Company and CUCL and Unicom New World, dated March 24, 2005. (English translation) (7). |
| 4.33           | Premise Leasing Agreement between CUCL, Unicom New World and A Share Company, dated March 24, 2005. (English translation) (7).  |
| 4.34           | Transfer Agreement of the Premise Leasing Agreement between A Share Company and Unicom New Guoxin, dated March 24, 2005. (English translation) (7).                               |
| 4.35           | Subscription Agreement between Unicom and SK Telecom Co., Ltd., dated June 20, 2006.*   |
| 8.1            | List of our significant subsidiaries (7).   |
| 11.1           | Code of Ethics for Senior Officers(6)   |
| 11.2           | Employee Code of Ethics (English translation)*  |
| 12.1           | Certification of Chief Executive Officer pursuant to Rule 13a-14(a)*  |
| 12.2           | Certification of Chief Financial Officer pursuant to Rule 13a-14(a)*  |
| 13.1           | Certification of Chief Executive Officer pursuant to Rule 13a-14(b)*  |
| 13.2           | Certification of Chief Financial Officer pursuant to Rule 13a-14(b)*  |

(1) Incorporated by reference to our Registration Statement on Form F-1 (File No. 333-11938) filed with the SEC in connection with our initial public offering in June 2000.

(2) Incorporated by reference to the Registration Statement on Form F-6 (Filed No. 333-11952) filed with the SEC with respect to American Depositary Shares representing our shares.

(3) Incorporated by reference to our Annual Report on Form 20-F (File No. 1-15028) for the year ended December 31, 2000.

(4) Incorporated by reference to our Annual Report on Form 20-F (File No. 1-15028) for the year ended December 31, 2001.

(5) Incorporated by reference to our Annual Report on Form 20-F (File No. 1-15028) for the year ended December 31, 2002.

(6) Incorporated by reference to our Annual Report on Form 20-F (File No. 1-15028) for the year ended December 31, 2003.

(7) Incorporated by reference to our Annual Report on Form 20-F (File No. 1-15028) for the year ended December 31, 2004.

\* Filed herewith.

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**SIGNATURE**

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.

Date: June 29, 2006

CHINA UNICOM LIMITED

By: /s/ Chang Xiaobing  
Name:  
Title:

Chang Xiaobing  
Chairman and Chief Executive Officer

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**CHINA UNICOM LIMITED AND ITS SUBSIDIARIES**

**AUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**FOR THE YEARS ENDED**

**DECEMBER 31, 2003, 2004 AND 2005**

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**INDEX OF CONSOLIDATED FINANCIAL STATEMENTS**

**CHINA UNICOM LIMITED AND ITS SUBSIDIARIES**

Report of Independent Registered Public Accounting Firm

Consolidated balance sheets as of December 31, 2004 and 2005

Consolidated statements of income for the years ended December 31, 2003, 2004 and 2005

Consolidated statements of changes in equity for the years ended December 31, 2003, 2004 and 2005

Consolidated statements of cash flows for the years ended December 31, 2003, 2004 and 2005

Notes to the consolidated financial statements



**Report of Independent Registered Public Accounting Firm**

**TO THE BOARD OF DIRECTORS AND SHAREHOLDERS OF CHINA UNICOM LIMITED**

*(Incorporated in the Hong Kong Special Administrative Region of the People's Republic of China ( Hong Kong ) with limited liability)*

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, of changes in equity and of cash flows present fairly, in all material respects, the financial position of China Unicom Limited and its subsidiaries (collectively referred to as the Group ) at December 31, 2004 and 2005, and the results of their operations and their cash flows for each of the three years then ended, in conformity with accounting principles generally accepted in Hong Kong. These financial statements are the responsibility of the Group's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States) and auditing standards generally accepted in Hong Kong, which 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, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 2.2 to these consolidated financial statements, the Group adopted the new/revised standards and interpretations of Hong Kong Financial Reporting Standards ( HKFRS ) in 2005. The adoption of new/revised HKFRS in 2005 resulted in changes in certain accounting policies which had been reflected in the financial statements either in accordance with the transitional provisions in the applicable accounting standards or, to the extent there are no transitional provisions, applied retrospectively so that the comparative figures presented have been restated, as applicable, to conform to the changes in accounting policies.

Accounting principles generally accepted in Hong Kong 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 37 to these consolidated financial statements.

**PricewaterhouseCoopers**  
*Certified Public Accountants*

Hong Kong, June 27, 2006

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**CHINA UNICOM LIMITED AND ITS SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
**AS OF DECEMBER 31, 2004 AND 2005**  
**(Expressed in thousands)**

|  | Note         | 2004<br>RMB<br>Restated<br>(Note 2.2) | 2005<br>RMB        | 2005<br>US\$      |
|--|--------------|---------------------------------------|--------------------|-------------------|
| <b>ASSETS</b>  |              |                                       |                    |                   |
| <b>Non-current assets</b>  |              |                                       |                    |                   |
| Property, plant and equipment  | 2.2,6        | 118,492,120                           | 116,056,432        | 14,380,862        |
| Goodwill   | 2.2,7        | 3,136,557                             | 3,143,983          | 389,579           |
| Other assets   | 2.2,8        | 9,694,761                             | 7,818,583          | 968,821           |
| Deferred income tax assets   | 2.2,9        | 468,774                               | 335,234            | 41,540            |
|  |              | 131,792,212                           | 127,354,232        | 15,780,802        |
| <b>Current assets</b>  |              |                                       |                    |                   |
| Inventories  | 10           | 3,114,632                             | 2,107,812          | 261,185           |
| Accounts receivable, net   | 11           | 5,229,980                             | 4,548,429          | 563,608           |
| Prepayments and other current assets                                   | 12           | 3,059,714                             | 2,342,467          | 290,261           |
| Amounts due from Domestic Carriers                                     | 32.2         | 269,919                               | 138,485            | 17,160            |
| Amounts due from Unicom Group  | 32.1         | 61,401                                |                    |                   |
| Amounts due from related parties                                       | 32.1         | 193,048                               | 384,531            | 47,648            |
| Short-term bank deposits   |              | 662,025                               | 282,457            | 35,000            |
| Bank balances and cash   | 13           | 4,655,464                             | 5,471,576          | 677,998           |
|  |              | 17,246,183                            | 15,275,757         | 1,892,860         |
| <b>Total assets</b>  |              | <b>149,038,395</b>                    | <b>142,629,989</b> | <b>17,673,662</b> |
| <b>EQUITY</b>  |              |                                       |                    |                   |
| <b>Capital and reserves attributable to the Company's shareholders</b> |              |                                       |                    |                   |
| Share capital  | 14           | 1,332,487                             | 1,333,621          | 165,253           |
| Share premium  | 14           | 52,546,294                            | 52,601,014         | 6,517,932         |
| Reserves   |              | 2,259,295                             | 2,827,331          | 350,342           |
| Retained profits   |              |                                       |                    |                   |
| - Proposed final dividend  | 30           | 1,256,349                             | 1,383,169          | 171,392           |
| - Others   |              | 15,047,816                            | 18,139,210         | 2,247,678         |
|  |              | 72,442,241                            | 76,284,345         | 9,452,597         |
| <b>Minority interest</b>   | 1.2, 1.5, 20 |                                       | 2,734              | 339               |
| <b>Total equity</b>  |              | <b>72,442,241</b>                     | <b>76,287,079</b>  | <b>9,452,936</b>  |

The accompanying notes are an integral part of the consolidated financial statements.



|   | Note | 2004<br>RMB<br>Restated<br>(Note 2.2) | 2005<br>RMB   | 2005<br>US\$ |
|---|------|---------------------------------------|---------------|--------------|
| <b>LIABILITIES</b>                                  |      |                                       |               |              |
| <b>Non-current liabilities</b>                      |      |                                       |               |              |
| Long-term bank loans                                | 15   | 26,137,188                            | 11,981,518    | 1,484,662    |
| Obligations under finance leases                    | 16   | 488,956                               | 145,367       | 18,013       |
| Deferred income tax liabilities                     | 9    | 3,262                                 | 5,613         | 695          |
| Deferred revenue                                    | 2.2  | 3,840,493                             | 3,348,232     | 414,887      |
| Other long-term liabilities                         |      | 2,578                                 |               |              |
|   |      | 30,472,477                            | 15,480,730    | 1,918,257    |
| <b>Current liabilities</b>                          |      |                                       |               |              |
| Payables and accrued liabilities                    | 17   | 16,785,749                            | 18,526,628    | 2,295,684    |
| Taxes payable                                       |      | 395,688                               | 1,016,128     | 125,911      |
| Amounts due to Domestic Carriers                    | 32.2 | 948,574                               | 822,006       | 101,857      |
| Amounts due to Unicom Group                         | 32.1 |                                       | 38,094        | 4,720        |
| Amounts due to related parties                      | 32.1 | 5,760                                 | 116,621       | 14,451       |
| Short-term bonds                                    | 18   |                                       | 9,865,900     | 1,222,510    |
| Short-term bank loans                               | 19   | 8,928,417                             | 7,024,358     | 870,407      |
| Current portion of long-term bank loans             | 15   | 11,086,305                            | 5,145,190     | 637,554      |
| Current portion of obligations under finance leases | 16   | 938,189                               | 420,631       | 52,122       |
| Advances from customers                             | 2.14 | 7,034,995                             | 7,886,624     | 977,253      |
|   |      | 46,123,677                            | 50,862,180    | 6,302,469    |
| <b>Total liabilities</b>                            |      | 76,596,154                            | 66,342,910    | 8,220,726    |
| <b>Total equity and liabilities</b>                 |      | 149,038,395                           | 142,629,989   | 17,673,662   |
| <b>Net current liabilities</b>                      |      | (28,877,494 )                         | (35,586,423 ) | (4,409,609 ) |
| <b>Total assets less current liabilities</b>        |      | 102,914,718                           | 91,767,809    | 11,371,193   |

The accompany notes are an integral part of the consolidated financial statements.

**CHINA UNICOM LIMITED AND ITS SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME**  
**FOR THE YEARS ENDED DECEMBER 31, 2003, 2004 AND 2005**  
**(Expressed in thousands, except per share data)**

|   | Note                | 2003<br>RMB<br>Restated<br>(Notes 2.2) | 2004<br>RMB<br>Restated<br>(Notes 2.2) | 2005<br>RMB   | 2005<br>US\$ |
|---|---------------------|--|--|---------------|--------------|
| Revenue (Turnover)  |                     |  |  |               |              |
| GSM Business  | 2.2, 5, 21, 32      | 41,152,781                             | 47,508,952                             | 52,135,528    | 6,460,252    |
| CDMA Business   | 2.2, 5, 21, 32      | 16,666,510                             | 24,377,674                             | 27,576,936    | 3,417,132    |
| Data and Internet Business                                | 5, 21, 32           | 3,437,083                              | 3,662,734                              | 3,049,967     | 377,930      |
| Long Distance Business                                    | 5, 21, 32           | 2,273,148                              | 1,848,009                              | 1,524,573     | 188,914      |
| Paging Business   | 1.2                 | 1,403,053                              |  |               |              |
| Total service revenue                                     |                     | 64,932,575                             | 77,397,369                             | 84,287,004    | 10,444,228   |
| Sales of telecommunications products                      | 2.2, 5, 21, 32      | 2,221,263                              | 1,689,755                              | 2,761,827     | 342,225      |
| Total revenue   | 2.2, 5, 21          | 67,153,838                             | 79,087,124                             | 87,048,831    | 10,786,453   |
| Leased lines and network capacities                       | 22, 32              | (4,320,382 )                           | (7,398,128 )                           | (8,747,317 )  | (1,083,903 ) |
| Interconnection charges                                   | 32                  | (5,920,793 )                           | (7,516,586 )                           | (8,372,370 )  | (1,037,443 ) |
| Depreciation and amortization                             | 2.2, 22             | (16,358,516 )                          | (19,011,074 )                          | (20,368,181 ) | (2,523,876 ) |
| Employee benefit expenses                                 | 2.2, 22, 23, 24, 25 | (4,596,253 )                           | (4,615,057 )                           | (5,616,312 )  | (695,932 )   |
| Selling and marketing                                     | 2.2, 22, 32         | (15,263,923 )                          | (19,523,280 )                          | (20,557,878 ) | (2,547,381 ) |
| General, administrative and other expenses                | 2.2, 22, 32         | (9,139,162 )                           | (10,500,241 )                          | (11,741,560 ) | (1,454,928 ) |
| Cost of telecommunications products sold                  | 2.2, 22, 32         | (2,938,949 )                           | (2,562,645 )                           | (3,575,316 )  | (443,027 )   |
| Loss on sale of discontinued operation<br>(Guoxin Paging) | 1.2                 | (663,279 )                             |  |               |              |
| Finance costs   | 26                  | (1,945,982 )                           | (1,696,075 )                           | (1,099,321 )  | (136,220 )   |
| Interest income   |                     | 173,033                                | 102,907                                | 96,196        | 11,920       |
| Other gains, net  |                     | 18,031                                 | 103,647                                | 34,925        | 4,328        |
| <b>Income before income tax</b>                           |                     | 6,197,663                              | 6,470,592                              | 7,101,697     | 879,991      |
| Income tax expenses                                       | 2.2, 9              | (1,929,143 )                           | (1,977,141 )                           | (2,170,411 )  | (268,941 )   |
| <b>Net income</b>   |                     | 4,268,520                              | 4,493,451                              | 4,931,286     | 611,050      |
| <b>Attributable to:</b>                                   |                     |  |  |               |              |
| Shareholders of the Company                               |                     | 4,278,149                              | 4,493,451                              | 4,931,052     | 611,021      |
| Minority interest   | 1.2, 1.5, 20        | (9,629 )                               |  | 234           | 29           |
|   |                     | 4,268,520                              | 4,493,451                              | 4,931,286     | 611,050      |
| Proposed final dividend                                   | 30                  | 1,255,317                              | 1,256,349                              | 1,383,169     | 171,392      |
| Dividend paid   | 30                  | 1,255,300                              | 1,256,160                              | 1,256,924     | 155,749      |

The accompany notes are an integral part of the consolidated financial statements.

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|   | Note    | 2003<br>RMB<br>Restated<br>(Note 2.2) | 2004<br>RMB<br>Restated<br>(Note 2.2) | 2005<br>RMB | 2005<br>US\$ |
|---|---------|---------------------------------------|---------------------------------------|-------------|--------------|
| <b>Earnings per share for income attributable to the shareholders</b> |         |                                       |                                       |             |              |
| Basic earnings per share  | 2.2, 29 | 0.34                                  | 0.36                                  | 0.39        | 0.05         |
| Diluted earnings per share  | 2.2, 29 | 0.34                                  | 0.36                                  | 0.39        | 0.05         |
| Number of shares outstanding for basic earnings (in thousands)        | 29      | 12,553,010                            | 12,561,242                            | 12,570,398  | 12,570,398   |
| Number of shares outstanding for diluted earnings (in thousands)      | 29      | 12,556,728                            | 12,593,054                            | 12,607,476  | 12,607,476   |
| Basic earnings per ADS  | 29      | 3.41                                  | 3.58                                  | 3.92        | 0.49         |
| Diluted earnings per ADS  | 29      | 3.41                                  | 3.57                                  | 3.91        | 0.48         |
| Number of ADS outstanding for basic earnings (in thousands)           | 29      | 1,255,301                             | 1,256,124                             | 1,257,040   | 1,257,040    |
| Number of ADS outstanding for diluted earnings (in thousands)         | 29      | 1,255,673                             | 1,259,305                             | 1,260,748   | 1,260,748    |

The accompany notes are an integral part of the consolidated financial statements.

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**CHINA UNICOM LIMITED**  
**CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY**  
**FOR THE YEARS ENDED DECEMBER 31, 2003, 2004 AND 2005**  
**(Expressed in thousands of RMB)**

|  | Share capital | Share premium | Employee share-based compensation reserve | Revaluation reserve | Statutory reserve | Retained profits | Minority Interest | Total        |
|--|---------------|---------------|---|---------------------|-------------------|------------------|-------------------|--------------|
| Balance at December 31, 2002, as previously reported as equity                       | 1,331,371     | 52,482,127    |   | 176,853             | 1,123,212         | 11,538,972       | 566,257           | 67,218,792   |
| Effects of changes of accounting policies upon adoption of HKFRS                     |               |               |   |                     |                   |                  |                   |              |
| Upfront non-refundable revenue and the related direct incremental cost (Note 2.2(d)) |               |               |   |                     |                   | (646,381 )       |                   | (646,381 )   |
| Balance at December 31, 2002, as restated  | 1,331,371     | 52,482,127    |   | 176,853             | 1,123,212         | 10,892,591       | 566,257           | 66,572,411   |
| Net income (Restated)  |               |               |   |                     |                   | 4,278,149        | (9,629 )          | 4,268,520    |
| Employees share option scheme:   |               |               |   |                     |                   |                  |                   |              |
| Value of employee services   |               |               | 21,707                                    |                     |                   |                  |                   | 21,707       |
| Exercise of options (Note 28)  | 19            | 1,139         |   |                     |                   |                  |                   | 1,158        |
| Appropriation to statutory reserve (Note 27)   |               |               |   |                     | 419,266           | (419,266 )       |                   |              |
| Dividends relating to 2002   |               |               |   |                     |                   | (1,255,300 )     |                   | (1,255,300 ) |
| Dividends paid to minority shareholders of Guoxin Paging (Note 1.2)                  |               |               |   |                     |                   |                  | (4,937 )          | (4,937 )     |
| Sale of discontinued operation (Guoxin Paging) (Note 1.2)                            |               |               |   |                     |                   |                  | (551,691 )        | (551,691 )   |
| Balance at December 31, 2003   | 1,331,390     | 52,483,266    | 21,707                                    | 176,853             | 1,542,478         | 13,496,174       |                   | 69,051,868   |
| Net income (Restated)  |               |               |   |                     |                   | 4,493,451        |                   | 4,493,451    |
| Employees share option scheme:   |               |               |   |                     |                   |                  |                   |              |
| Value of employee services   |               |               | 88,957                                    |                     |                   |                  |                   | 88,957       |
| Exercise of options (Note 28)  | 1,097         | 63,028        |   |                     |                   |                  |                   | 64,125       |
| Appropriation to statutory reserve (Note 27)   |               |               |   |                     | 429,300           | (429,300 )       |                   |              |
| Dividends relating to 2003   |               |               |   |                     |                   | (1,256,160 )     |                   | (1,256,160 ) |
| Balance at December 31, 2004   | 1,332,487     | 52,546,294    | 110,664                                   | 176,853             | 1,971,778         | 16,304,165       |                   | 72,442,241   |
| Derecognition of negative goodwill (Note 2.2(c))                                     |               |               |   |                     |                   | 7,425            |                   | 7,425        |
| Balance at January 1, 2005, as restated  | 1,332,487     | 52,546,294    | 110,664                                   | 176,853             | 1,971,778         | 16,311,590       |                   | 72,449,666   |
| Net income   |               |               |   |                     |                   | 4,931,052        | 234               | 4,931,286    |
| Subscription of shares of a subsidiary by minority shareholder (Note 1.5)            |               |               |   |                     |                   |                  | 2,500             | 2,500        |
| Employee share option scheme:  |               |               |   |                     |                   |                  |                   |              |
| Value of employee services   |               |               | 108,417                                   |                     |                   |                  |                   | 108,417      |
| Recognition of share issued on exercise of options (Note 28)                         | 1,134         | 54,720        | (3,720 )                                  |                     |                   |                  |                   | 52,134       |
| Appropriation to statutory reserve (Note 27)   |               |               |   |                     | 463,339           | (463,339 )       |                   |              |
| Dividends relating to 2004 (Note 30)   |               |               |   |                     |                   | (1,256,924 )     |                   | (1,256,924 ) |
| Balance at December 31, 2005   | 1,333,621     | 52,601,014    | 215,361                                   | 176,853             | 2,435,117         | 19,522,379       | 2,734             | 76,287,079   |

The accompany notes are an integral part of the consolidated financial statements.

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**CHINA UNICOM LIMITED**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**FOR THE YEARS ENDED DECEMBER 31, 2003, 2004 AND 2005**  
**(Expressed in thousands)**

|  | Note | 2003<br>RMB<br>Restated<br>(Note 2.2) | 2004<br>RMB<br>Restated<br>(Note 2.2) | 2005<br>RMB   | 2005<br>US\$ |
|--|------|---------------------------------------|---------------------------------------|---------------|--------------|
| <b>Cash flows from operating activities</b>  | (a)  | 26,449,770                            | 27,703,311                            | 33,974,778    | 4,209,905    |
| Interest received  |      | 204,025                               | 106,365                               | 95,731        | 11,862       |
| Interest paid  |      | (2,540,513 )                          | (2,310,270 )                          | (1,792,398 )  | (222,101 )   |
| Dividends received   |      | 2,573                                 |                                       |               |              |
| Dividends paid to minority owners of subsidiaries  |      | (4,689 )                              |                                       |               |              |
| PRC income tax paid  |      | (1,545,907 )                          | (1,680,111 )                          | (1,474,423 )  | (182,700 )   |
| Net cash generated from operating activities   |      | 22,565,259                            | 23,819,295                            | 30,803,688    | 3,816,966    |
| <b>Cash flows from investing activities</b>  |      |                                       |                                       |               |              |
| Purchase of property, plant and equipment  |      | (21,145,882 )                         | (18,939,138 )                         | (16,643,005 ) | (2,062,279 ) |
| Proceeds from sale of property, plant and equipment                                      |      | 94,804                                | 53,970                                | 91,851        | 11,382       |
| Decrease in short-term bank deposits   |      | 3,832,411                             | 250,769                               | 379,568       | 47,033       |
| Payment of direct acquisition cost of Unicom New Century                                 |      | (59,767 )                             | (4,566 )                              |               |              |
| Purchase of Unicom New World, net of cash acquired                                       |      | (2,326,449 )                          |                                       |               |              |
| Payment of direct acquisition cost of Unicom New World                                   | 1.1  |                                       | (14,039 )                             |               |              |
| Purchase of Unicom International, net of cash acquired                                   | 1.3  |                                       | 44,267                                |               |              |
| Purchase of trading securities   |      | (87,956 )                             |                                       |               |              |
| Proceeds from of sale of trading securities  |      | 118,575                               |                                       |               |              |
| Purchase of investment in associated companies   |      | (10,062 )                             |                                       |               |              |
| Proceeds from of sale of investment in associated companies                              |      | 853                                   |                                       |               |              |
| Proceeds from of sale of investment securities   |      | 19,753                                |                                       |               |              |
| Proceeds from of sale of Guoxin Paging, net of cash disposed                             | 1.2  | 1,259,159                             | 450,000                               |               |              |
| Purchase of other assets   |      | (746,742 )                            | (799,866 )                            | (576,755 )    | (71,467 )    |
| Net cash used in investing activities  |      | (19,051,303 )                         | (18,958,603 )                         | (16,748,341 ) | (2,075,331 ) |
| <b>Cash flows from financing activities</b>  |      |                                       |                                       |               |              |
| Proceeds from exercise of share options  |      | 1,158                                 | 64,125                                | 52,134        | 6,460        |
| Repayment to Unicom Group  |      | (724,127 )                            |                                       |               |              |
| Proceeds from minority interest of a subsidiary in respect of share capital contribution |      |                                       |                                       | 2,500         | 310          |
| Proceeds from short-term bonds   |      |                                       |                                       | 9,690,800     | 1,200,813    |
| Proceeds from short-term bank loans  |      | 10,901,425                            | 10,224,971                            | 12,532,071    | 1,552,882    |
| Proceeds from long-term bank loans   |      | 11,075,836                            | 11,083,383                            | 5,798,657     | 718,527      |
| Repayment of short-term bank loans   |      | (10,278,727 )                         | (12,271,753 )                         | (20,104,146 ) | (2,491,158 ) |
| Repayment of long-term bank loans  |      | (18,497,783 )                         | (17,245,641 )                         | (19,928,416 ) | (2,469,382 ) |
| Dividends paid   | 30   | (1,255,300 )                          | (1,256,160 )                          | (1,256,924 )  | (155,749 )   |
| Net cash used in financing activities  |      | (8,777,518 )                          | (9,401,075 )                          | (13,213,324 ) | (1,637,297 ) |
| <b>Net (decrease)/increase in cash and cash equivalents</b>                              |      | (5,263,562 )                          | (4,540,383 )                          | 842,023       | 104,338      |
| Cash and cash equivalents, beginning of year   |      | 14,433,498                            | 9,169,936                             | 4,629,553     | 573,660      |
| <b>Cash and cash equivalents, end of year</b>  | 13   | 9,169,936                             | 4,629,553                             | 5,471,576     | 677,998      |
| <b>Analysis of the balances of cash and cash equivalents:</b>                            |      |                                       |                                       |               |              |
| Cash balances  |      | 4,610                                 | 4,756                                 | 9,319         | 1,155        |
| Bank balances  |      | 9,215,326                             | 4,650,708                             | 5,462,257     | 676,843      |
| Less: Restricted bank deposits   | (i)  | (50,000 )                             | (25,911 )                             |               |              |
|  |      | 9,169,936                             | 4,629,553                             | 5,471,576     | 677,998      |

Note (i): As of December 31, 2005, no bank balances (2003: RMB50 million; 2004: RMB26 million) were restricted by the bank as collateral for long-term bank loans.

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(a) The reconciliation of net income to net cash inflow from operating activities was as follows:

|   | 2003<br>RMB<br>Restated<br>(Note 2.2) | 2004<br>RMB<br>Restated<br>(Note 2.2) | 2005<br>RMB  | 2005<br>US\$ |
|---|---------------------------------------|---------------------------------------|--------------|--------------|
| Net income  | 4,268,520                             | 4,493,451                             | 4,931,286    | 611,050      |
| Adjustments for:  |                                       |                                       |              |              |
| Income tax  | 1,929,143                             | 1,977,141                             | 2,170,411    | 268,941      |
| Depreciation and amortization   | 16,358,516                            | 19,011,074                            | 20,368,181   | 2,523,876    |
| Amortization of deferred customer acquisition costs of contractual CDMA subscribers | 5,836,587                             | 6,120,737                             | 5,947,631    | 736,987      |
| Interest income   | (173,033 )                            | (102,907 )                            | (96,196 )    | (11,920 )    |
| Interest expense  | 1,919,375                             | 1,668,467                             | 1,060,271    | 131,381      |
| Loss on sale of discontinued operation (Guoxin Paging)                              | 663,279                               |                                       |              |              |
| Loss on disposal of property, plant and equipment                                   | 49,940                                | 10,537                                | 25,134       | 3,114        |
| Provision for impairment loss of property, plant and equipment                      | 528,048                               |                                       |              |              |
| Share of losses from associated companies   | 2,275                                 |                                       |              |              |
| Dividends from investment securities  | (2,573 )                              |                                       |              |              |
| Realized gains on trading securities  | (12,045 )                             |                                       |              |              |
| Unrealized gains on trading securities  | (10,129 )                             |                                       |              |              |
| Realized gains on investment securities   | (13,268 )                             |                                       |              |              |
| Share-based compensation costs  | 21,707                                | 88,957                                | 108,417      | 13,434       |
| Provision for doubtful debts  | 1,749,887                             | 2,191,820                             | 1,498,510    | 185,684      |
| Changes in working capital:   |                                       |                                       |              |              |
| Increase in accounts receivable   | (2,650,625 )                          | (1,915,496 )                          | (816,959 )   | (101,232 )   |
| Decrease/(increase) in inventories  | 1,263,299                             | (939,899 )                            | 1,006,820    | 124,758      |
| Increase in other assets  | (3,748,996 )                          | (5,536,980 )                          | (2,738,580 ) | (339,345 )   |
| Increase in prepayments and other current assets                                    | (1,342,086 )                          | (792,416 )                            | (477,665 )   | (59,189 )    |
| (Increase)/decrease in amounts due from Domestic Carriers                           | (22,227 )                             | (85,306 )                             | 131,434      | 16,286       |
| Decrease in amounts due from Unicom Group   |                                       |                                       | 61,401       | 7,608        |
| Decrease/(increase) in amounts due from related parties                             | 553,354                               | 70,516                                | (191,483 )   | (23,727 )    |
| (Decrease)/increase in payables and accrued liabilities                             | (35,732 )                             | 1,835,813                             | 604,410      | 74,894       |
| (Decrease)/increase in advances from customers                                      | (55,497 )                             | 367,431                               | 851,629      | 105,528      |
| Increase/(decrease) in deferred revenue   | 482,486                               | 244,486                               | (492,261 )   | (60,997 )    |
| (Decrease)/increase in amounts due to Domestic Carriers                             | (161,937 )                            | 169,733                               | (126,568 )   | (15,683 )    |
| (Decrease)/increase in amounts due to Unicom Group                                  | (562,633 )                            | (943,448 )                            | 38,094       | 4,720        |
| (Decrease)/increase in amounts due to related parties                               | (385,865 )                            | (230,400 )                            | 110,861      | 13,737       |
| Cash flow from operating activities   | 26,449,770                            | 27,703,311                            | 33,974,778   | 4,209,905    |

(b) Supplemental information:

Payables to equipment suppliers for construction-in-progress during 2005 increased by approximately RMB633 million (2003 and 2004: decreased by approximately RMB3,234 million and RMB775 million respectively).

The accompany notes are an integral part of the consolidated financial statements.



**CHINA UNICOM LIMITED AND ITS SUBSIDIARIES**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**(Amounts expressed in RMB thousands unless otherwise stated)**

**1. ORGANISATION AND PRINCIPAL ACTIVITIES**

China Unicom Limited (the Company) was incorporated as a limited liability company in the Hong Kong Special Administrative Region ( Hong Kong ), the People's Republic of China (the PRC) on February 8, 2000. The principal activities of the Company are investment holding and the Company's subsidiaries are engaged in the provision of GSM and CDMA cellular, data, Internet and long distance services in the PRC. The GSM and CDMA business hereinafter collectively refer to as the Cellular Business. The Company and its subsidiaries are hereinafter referred to as the Group. The address of its registered office is 75th Floor, The Center, 99 Queen's Road Central, Hong Kong.

The shares of the Company were listed on the Stock Exchange of Hong Kong Limited on June 22, 2000 and the American Deposit Stock of the Company were listed on The New York Stock Exchange Inc. on June 21, 2000.

The immediate holding company of the Company is China Unicom (BVI) Limited ( Unicom BVI ). The majority of the equity interests in Unicom BVI is owned by China United Telecommunications Corporation Limited (a joint stock company incorporated in the PRC on December 31, 2001, with its A shares listed on the Shanghai Stock Exchange on October 9, 2002). The majority of the equity interest in China United Telecommunications Corporation Limited is owned by China United Telecommunications Corporation (a state-owned enterprise established in the PRC, hereinafter referred as Unicom Group). The directors of the Company consider Unicom Group to be the ultimate parent company.

The Group completed the following acquisitions, sale and activities in 2003, 2004 and 2005 respectively:

**1.1 Acquisition of Unicom New World Telecommunications Corporation Limited ( Unicom New World )**

In 2003, the Company acquired the entire equity interests in Unicom New World from Unicom Group (via the intermediary holding company, Unicom New World (BVI) Limited). Unicom New World is a limited liability company established in the PRC on November 4, 2003 to engage in the provision of GSM and CDMA cellular telecommunications services in 6 provinces and 3 autonomous regions in the PRC. The Cellular Business of Unicom New World and the relevant net assets were previously owned and operated by various branches of Unicom Group.

Pursuant to the resolution passed by the Company's Board of Directors on November 20, 2003 and the extraordinary general meeting of the Company's shareholders on December 23, 2003, the Company acquired the entire equity interests in Unicom New World at a cash consideration of approximately RMB3,249 million (including direct costs of acquisition of approximately RMB49 million). After all the conditions to the acquisition were satisfied and cash consideration was settled by the Group, the acquisition of Unicom New World became effective on December 31, 2003. The Company has adopted the purchase method of accounting to account for this acquisition of entity under common control of Unicom Group, according to the previous Hong Kong Statement of Standard Accounting Practice 27 Accounting for Group Reconstructions. The total fair value of the identifiable assets and liabilities of Unicom New World as of December 31, 2003 amounted to approximately RMB2,104 million, the excess of purchase consideration over the fair value of identifiable assets and liabilities has been recorded as goodwill amounting to approximately RMB1,145 million (Note 7).

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As this acquisition was effective on December 31, 2003, both the operating results and the financial position of Unicom New World have been included in the consolidated financial statements of the Group for the years ended December 31, 2004 and 2005. However, the 2003 comparatives only reflected the financial position of Unicom New World in the consolidated balance sheets and excluded the operating results of Unicom New World in the consolidated statements of income of the Group.

The fair value of the net assets acquired and net cash outflow in respect of the acquisition of Unicom New World as of December 31, 2003 was as follows:

|  | Note | As of December 31,<br>2003<br>RMB 000 |
|--|------|---------------------------------------|
| The fair value of the net assets acquired:   |      |                                       |
| Property, plant and equipment  |      | 12,106,458                            |
| Other assets   |      | 583,827                               |
| Deferred income tax assets   |      | 206,928                               |
| Amounts due from related parties   |      | 207,237                               |
| Amounts due from Domestic Carriers   |      | 5,745                                 |
| Prepayments and other current assets   |      | 283,287                               |
| Inventories  |      | 307,503                               |
| Accounts receivable, net   |      | 357,880                               |
| Bank balances and cash   | (i)  | 923,551                               |
| Payables and accrued liabilities   |      | (1,951,215 )                          |
| Amounts due to Unicom Group  |      | (1,005,135 )                          |
| Amounts due to related parties   |      | (324,597 )                            |
| Amounts due to Domestic Carriers   |      | (52,473 )                             |
| Current portion of long-term bank loans  |      | (2,213,216 )                          |
| Long-term bank loans   |      | (5,473,734 )                          |
| Taxes payable  |      | (46,764 )                             |
| Advances from customers  |      | (604,862 )                            |
| Short-term bank loans  |      | (1,206,000 )                          |
|  |      | 2,104,420                             |
| Goodwill   |      | 1,144,957                             |
| Less: direct costs of acquisition  |      | (49,377 )                             |
| Consideration paid   |      | 3,200,000                             |
| The net cash outflow in respect of the acquisition of Unicom New World was as follows: |      |                                       |
| Cash consideration   |      | 3,200,000                             |
| Bank balances and cash acquired (less restricted bank deposits)                        | (i)  | (873,551 )                            |
| Net cash outflow in respect of the acquisition of Unicom New World                     |      | 2,326,449                             |

Note (i): As of December 31, 2003, approximately RMB50 million of bank balances were restricted by the bank as collateral the long-term bank loans.

## 1.2 Sale of Guoxin Paging Corporation Limited ( Guoxin Paging )

In 2003, China Unicom Corporation Limited (hereinafter referred to as CUCL , a direct wholly-owned subsidiary of the Company) sold the entire equity interests in Guoxin Paging to Unicom Group. Guoxin Paging was established as a limited liability company in the PRC in September 1998. Guoxin Paging originally operated a nationwide paging business through its 31 subsidiaries and branches in 27 provinces and autonomous regions and 4 municipalities in the PRC and was wholly-owned by CUCL. In 2003, minority interests only existed in Unicom Guomai Communications Corporation Limited (hereinafter referred to as Unicom Guomai ), a subsidiary of Guoxin Paging (58.88% owned by Guoxin Paging which has been disposed together with Guoxin Paging on December 31, 2003).

The Group originally had 5 operating segments namely GSM Business, CDMA Business, Data and Internet Business, Long Distance Business and Paging Business (see Note 5). Pursuant to the ordinary resolution passed by the Company's Board of Directors on November 20, 2003 and the extraordinary general meeting of the Company's shareholders on December 23, 2003, the Company completed the sale of the entire equity interests of Guoxin Paging to Unicom Group at a cash consideration of RMB2,750 million.

The sale of Guoxin Paging became effective on December 31, 2003 after all the conditions to the sale were satisfied, the majority of cash proceeds was settled by Unicom Group, and ownership as well as control was passed to Unicom Group. The total net assets of Guoxin Paging as of December 31, 2003 amounted to approximately RMB3,413 million, and the difference between the sale proceeds and the net assets disposed amounting to approximately RMB663 million, has been recorded as the loss on sale of discontinued operation in 2003. Net cash inflow received from Unicom Group in respect of the sales of Guoxin Paging in years 2003 and 2004 amounted to approximately RMB1,259,159,000 and RMB450,000,000 respectively.

Since the effective date of this sale was December 31, 2003, the operating results of Guoxin Paging have been included in the consolidated statements of income of the Group up to this date. For the year ended December 31, 2003, the operating revenue and loss after taxation of Guoxin Paging amounted to approximately RMB2,387 million and RMB1,404 million respectively.

In addition, pursuant to the resolution passed in 2003, Unicom Guomai declared dividends approximately RMB4.9 million to its minority owners.

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(a) The net assets sold and net cash inflow in respect of the sale of Guoxin Paging as of December 31, 2003 was as follows:

|  | <b>As of December 31,<br/>2003<br/>RMB 000</b> |
|--|--|
| Net assets sold:   |  |
| Property, plant and equipment  | 3,647,083                                      |
| Other assets   | 151,067  |
| Investment securities  | 99,157   |
| Investment in associated companies   | 17,185   |
| Amounts due from Unicom Group  | 9,440  |
| Amounts due from related parties   | 277,457  |
| Amounts due from Domestic Carriers   | 54,821   |
| Prepayments and other current assets   | 207,813  |
| Inventories  | 104,753  |
| Accounts receivable, net   | 107,632  |
| Trading securities   | 165,493  |
| Short-term bank deposits   | 80,000   |
| Bank balances and cash   | 1,040,841                                      |
| Dividend payable   | (8,260 )                                       |
| Payables and accrued liabilities   | (1,491,890 )                                   |
| Amounts due to related parties   | (121,173 )                                     |
| Amounts due to Domestic Carriers   | (235,275 )                                     |
| Taxes payable  | (17,669 )                                      |
| Advances from customers  | (123,505 )                                     |
| Minority interests   | (551,691 )                                     |
|  | 3,413,279                                      |
| Less: sale proceeds  | (2,750,000 )                                   |
| Loss on sale of discontinued operation   | 663,279  |
| The net cash inflow in respect of the sale of discontinued operation was as follows: |  |
| Sale proceeds received   | 2,300,000                                      |
| Bank balances and cash disposed  | (1,040,841 )                                   |
| Net cash inflow in respect of the sale of discontinued operation                     | 1,259,159                                      |

(b) The operating results of the Group attributable to the continuing operations and discontinued operation (Guoxin Paging) were as follows:

|  | Continuing operations<br>2003<br>RMB 000 | Discontinued operation<br>(Guoxin Paging)<br>2003<br>RMB 000 | Group as a whole<br>2003<br>RMB 000 |
|--|--|--|-------------------------------------|
| Revenue (Turnover)                     | 64,766,755                               | 2,387,083  | 67,153,838                          |
| Operating expenses                     | (54,947,285)                             | (3,590,693)  | (58,537,978)                        |
| Operating income (loss)                | 9,819,470                                | (1,203,610)  | 8,615,860                           |
| Loss on sale of discontinued operation |  | (663,279)  | (663,279)                           |
| Finance costs                          | (1,940,744)                              | (5,238)  | (1,945,982)                         |
| Interest income                        | 163,934                                  | 9,099  | 173,033                             |
| Other (loss) income, net               | (21,837)                                 | 39,868   | 18,031                              |
| Income (loss) before taxation          | 8,020,823                                | (1,823,160)  | 6,197,663                           |
| Taxation                               | (2,348,358)                              | 419,215  | (1,929,143)                         |
| Income (loss) after taxation           | 5,672,465                                | (1,403,945)  | 4,268,520                           |

(c) The cash flows of the Group attributable to the continuing operations and discontinued operation (Guoxin Paging) were as follows:

|  | Continuing operations<br>2003<br>RMB 000 | Discontinued operation<br>(Guoxin Paging)<br>2003<br>RMB 000 | Group as a whole<br>2003<br>RMB 000 |
|--|--|--|-------------------------------------|
| Net cash inflow from operating activities            | 22,141,521                               | 423,738  | 22,565,259                          |
| Net cash outflow from investing activities           | (18,660,174)                             | (391,129)  | (19,051,303)                        |
| Net cash outflow from financing activities           | (8,752,829)                              | (24,689)   | (8,777,518)                         |
| Net (decrease)/increase in cash and cash equivalents | (5,271,482)                              | 7,920  | (5,263,562)                         |

Guoxin Paging subsequently changed its name to Unicom New Guoxin Telecommunications Corporation Limited (hereinafter referred to as New Guoxin ) on April 29, 2004.

### **1.3 Acquisition of China Unicom International Limited ( Unicom International )**

In 2004, the Company acquired the entire equity interests in Unicom International, which is a wholly-owned subsidiary of China Unicom (Hong Kong) Group Limited (a wholly-owned subsidiary of Unicom Group, hereinafter referred to as Unicom Group (HK) ). Unicom International is a limited liability company established in Hong Kong on May 24, 2000 to engage in voice wholesale business, telephone cards business, line leasing services, managed bandwidth services and mobile virtual network services. Unicom International's wholly-owned US subsidiary, China Unicom USA Corporation ( Unicom USA ), carries on a wholesale voice business for traffic between US and mainland China.

Pursuant to the acquisition agreement signed between Unicom Group (HK) and the Company dated July 28, 2004, the Company agreed to acquire the entire equity interests in Unicom International from Unicom Group (HK) for a cash consideration of HK\$37,465,996 (equivalent to approximately RMB39,740,000, including direct costs of acquisition). After all the conditions to the acquisition were satisfied and cash consideration was settled by the Company, the acquisition of Unicom International became effective in September 2004. The Company has adopted the purchase method of accounting to account for this acquisition of entity under common control of Unicom Group, according to the previous Hong Kong Statement of Standard Accounting Practice 27 Accounting for Group Reconstructions . The total fair value of the identifiable assets and liabilities of Unicom International in September 2004 amounted to approximately RMB47 million. The excess of the fair value of the identifiable assets and liabilities over purchase consideration has been recorded as negative goodwill amounting to RMB7.73 million (Note 7) in 2004.

As this acquisition was effective in September 2004, accordingly, the operating results of Unicom International for the period from the acquisition effective date have been included in the consolidated statements of income of the Group.

### **1.4 Incorporation of China Unicom (Macau) Company Limited ( Unicom Macau )**

On October 15, 2004, the Company together with Unicom International set up and incorporated Unicom Macau in Macau Special Administrative Region of the PRC ( Macau ) to engage in CDMA telecommunication business. The Company effectively held 100% of the entire issued capital of Unicom Macau.

### **1.5 Incorporation of Unicom Huasheng Telecommunications Technology Company Limited ( Unicom Huasheng )**

On July 1, 2005, CUCL together with Unicom Xingye Science and Technology Trade Co. ( Unicom Xingye , a subsidiary of Unicom Group) set up and incorporated Unicom Huasheng. Unicom Huasheng is principally engaged in sales of handsets and telecommunication equipment and provision of technical services. CUCL effectively held 95% in the entire issued capital of Unicom Huasheng. The paid-in capital of Unicom Huasheng as of December 31, 2005 was RMB50 million, CUCL has contributed a capital of RMB47.5 million, whereas the minority shareholder Unicom Xingye contributed the remaining capital of RMB2.5 million.

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## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The principal accounting policies applied in the preparation of these consolidated financial statements are set out below. These policies have been consistently applied to all the years presented, unless otherwise stated.

### 2.1 Basis of Preparation

The consolidated financial statements have been prepared under the historical cost convention except that, certain buildings are stated at fair value. They have been prepared in accordance with Hong Kong Financial Reporting Standards ( HKFRS ) issued by the Hong Kong Institute of Certified Public Accountants ( HKICPA ). This basis of accounting differs from that used in the preparation of statutory financial statements for PRC statutory reporting purposes, which are based on the accounting principles and financial regulations applicable to enterprises established in the PRC ( PRC GAAP ).

The principal adjustments made to conform to HKFRS include the following:

- Reversal of revaluation surplus and related depreciation and amortization charges arising from the revaluation of assets performed by independent valuers registered in the PRC;
- Additional accrual for retirement benefits;
- Additional provision for housing benefits;
- Additional capitalization of borrowing costs;
- Provision for deferred taxation on HKFRS adjustments;
- Capitalization of the direct costs associated with the acquisition of subsidiaries;
- Recognition of employee share-based compensation costs (Note 2.2(b));
- Reversal of goodwill amortization and recognition of negative goodwill in opening retained earnings (Note 2.2(c)); and
- Capitalization and amortization of upfront non-refundable revenue and the related direct incremental costs for activating cellular subscribers (Note 2.2(d)).

As of December 31, 2005, the current liabilities of the Group had exceeded the current assets by approximately RMB35.6 billion (2004: RMB28.9 billion). This was mainly attributable to the use of short-term bank deposits and short-term bonds to repay long-term bank loans. Taking into account of available financing facilities and continuous net cash inflows from operating activities, the Group has sufficient funds to meet its working capital requirements and debt obligations. As a result, the consolidated financial statements of the Group for the years ended December 31, 2004 and 2005 have been prepared under the going concern basis.

The preparation of the consolidated financial statements of the Group in conformity with HKFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgment in the process of applying the Group's accounting policies. The areas involving a higher degree of judgment or complexity, or areas where assumptions and estimates were significant to the consolidated financial statements are disclosed in Note 4.

## 2.2 The Adoption of New/Revised HKFRS

In 2005, the Group adopted the new/revised standards and interpretations of HKFRS below, which are relevant to its operations. The 2003 and 2004 comparatives have been amended as required, in accordance with the relevant requirements.

|             |   |
|-------------|---|
| HKAS 1      | Presentation of Financial Statements                            |
| HKAS 2      | Inventories   |
| HKAS 7      | Cash Flow Statements  |
| HKAS 8      | Accounting Policies, Changes in Accounting Estimates and Errors |
| HKAS 10     | Events after the Balance Sheet Date                             |
| HKAS 16     | Property, Plant and Equipment                                   |
| HKAS 17     | Leases  |
| HKAS 21     | The Effects of Changes in Foreign Exchange Rates                |
| HKAS 23     | Borrowing Costs   |
| HKAS 24     | Related Party Disclosures                                       |
| HKAS 27     | Consolidated and Separate Financial Statements                  |
| HKAS 28     | Investments in Associates                                       |
| HKAS 31     | Investments in Joint Ventures                                   |
| HKAS 32     | Financial Instruments: Disclosures and Presentation             |
| HKAS 33     | Earnings per Share  |
| HKAS 36     | Impairment of Assets  |
| HKAS 38     | Intangible Assets   |
| HKAS 39     | Financial Instruments: Recognition and Measurement              |
| HKAS Int 15 | Operating Leases - Incentives                                   |
| HKFRS 2     | Share-based Payments  |
| HKFRS 3     | Business Combinations   |

The adoption of new/revised HKASs 2, 7, 8, 10, 16, 21, 23, 27, 28, 31, 32, 33, 39 and HKAS Int 15 did not result in substantial changes to the Group's accounting policies.

- HKASs 2, 7, 8, 10, 16, 23, 27, 28, 33 and HKAS-Int 15 had no material effect on the Group's policies.
- HKAS 21 had no material effect on the Group's policy. The functional currency of the consolidated entities has been re-evaluated based on the guidance to the revised standard. All the Group entities have the same functional currency as the presentation currency for respective entity financial statements.

The adoption of revised HKAS 1 has affected the presentation of minority interests. In prior years, the minority interests were presented in the consolidated balance sheets separately from liabilities and as deduction from net assets. Minority interests in the results of the Group for the years were also separately presented in the consolidated statements of income as a deduction before arriving at the net income. With effect from January 1, 2005, minority interests at the balance sheet date are presented in the consolidated balance sheets within equity, separately from the equity attributable to the Company's shareholders. In addition, minority interests in the results of the Group are presented on the face of the consolidated statements of income as an allocation of the net income between minority interests and the shareholders of the Company. The presentation of minority interests in the consolidated balance sheets and consolidated statements of income for the comparative periods has been restated accordingly.

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The adoption of revised HKAS 17 has resulted in a change in the accounting policy relating to the reclassification of leasehold land and land use rights from property, plant and equipment to other assets - long-term prepayment for lease of land. The upfront prepayments made for the leasehold land and land use rights are expensed in the statements of income on a straight-line basis over the period of the lease. In prior years, the leasehold land was accounted for at cost less accumulated depreciation.

HKAS 24 has extended the identification of related parties and disclosure of related parties to include state-owned enterprises. Related parties include Unicom Group and its related parties, other state-owned enterprises and their subsidiaries directly or indirectly controlled by the PRC government (other than those shown on the face of balance sheets as related parties), other entities and corporations in which the Company is able to control, jointly control or exercise significant influence and key management personnel of the Company and Unicom Group as well as their close family members.

The adoption of HKFRS 2 has resulted in a change in the accounting policy for share-based payments. Until December 31, 2004, the provision of share options to employees did not result in an expense in the statements of income. Effective on January 1, 2005, the Group expenses the cost of share options in the statements of income over the vesting period of the options. As a transitional provision, the cost of share options granted after November 7, 2002 and not yet vested on January 1, 2005 was expensed retrospectively in the statements of income of the respective periods.

The adoption of HKFRS 3, HKAS 36 and HKAS 38 has resulted in a change in the accounting policy for goodwill/ negative goodwill. Until December 31, 2004, goodwill was amortized on a straight-line basis over 20 years, and assessed for any indication of impairment at each balance sheet date.

In accordance with the provisions of HKFRS 3, the Group ceased amortization of goodwill from January 1, 2005, and the accumulated amortization as of December 31, 2004 has been eliminated with a corresponding decrease in the cost of goodwill. Starting from January 1, 2005 onwards, goodwill is no longer amortized but is tested for impairment on an annual basis, as well as when there is indication of impairment.

In addition, in accordance with HKFRS 3, from January 1, 2005, if the fair value of the net identifiable assets and liabilities acquired exceed the purchase consideration (i.e. an amount arises which would have been recorded as negative goodwill under the previous accounting policy), the excess is recognized immediately in the consolidated statements of income as it arises. Negative goodwill previously recognized has been derecognized at January 1, 2005, with a corresponding adjustment to the opening balance of retained earnings of the Group.

Upon the adoption of HKFRS on January 1, 2005, the Group changed its accounting policy for recognition of upfront non-refundable revenue, such as connection fee and receipts from SIM/UIM cards, which had previously been recognized upon the completion of activation services. Effective from January 1, 2005, upfront non-refundable revenue and the related direct incremental costs for activating cellular subscribers (including costs of SIM/UIM cards and commissions) are capitalized and amortized over the expected customer service periods. Direct incremental costs are capitalized only to the extent expected to be recoverable. The expected customer service period for the Cellular Business is estimated based on the expected stabilized churn rates of subscribers. Management judges that this change of accounting policy provides reliable and more relevant information because it better reflects the economic effects of the transactions.

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All changes in the accounting policies have been made in accordance with the transitional provisions in the respective standards, wherever applicable. All standards adopted by the Group require retrospective application other than:

- HKFRS 2 only retrospective application for all equity instruments granted after November 7, 2002 and not vested at January 1, 2005; and
- HKFRS 3 prospectively after January 1, 2005.

The following tables summarized the effects of adoption of new accounting policies in 2003, 2004 and 2005:

The following table disclosed the adjustments that have been made in accordance with the transitional provisions of the respective new/revised HKFRSs or the provisions of HKAS 8 to net income in the consolidated statements of income for the year ended December 31, 2003.

| RMB in millions<br>(except per share data)              | Effect of new policies in 2003 |                            |                            | Change in<br>accounting<br>policy for<br>revenue<br>recognition<br>(Note 2.2 (d)) | Total |
|---|--------------------------------|----------------------------|----------------------------|---|-------|
|   | HKAS 17<br>(Notes 2.2 (a))     | HKFRS 2<br>(Notes 2.2 (b)) | HKAS 38<br>(Notes 2.2 (c)) |   |       |
| (Decrease)/increase of net income                       |                                | (22 )                      |                            | 83  | 61    |
| (Decrease)/increase of basic earnings per share (RMB)   |                                | (0.002 )                   |                            | 0.007   | 0.005 |
| (Decrease)/increase of diluted earnings per share (RMB) |                                | (0.002 )                   |                            | 0.007   | 0.005 |

The following table disclosed the adjustments that have been made in accordance with the transitional provisions of the respective new/revised HKFRSs or the provisions of HKAS 8 to net income in the consolidated statements of income for the year ended December 31, 2004.

| RMB in millions<br>(except per share data)              | Effect of new policies in 2004 |                            |                            | Change in<br>accounting<br>policy for<br>revenue<br>recognition<br>(Note 2.2 (d)) | Total |
|---|--------------------------------|----------------------------|----------------------------|---|-------|
|   | HKAS 17<br>(Notes 2.2 (a))     | HKFRS 2<br>(Notes 2.2 (b)) | HKAS 38<br>(Notes 2.2 (c)) |   |       |
| (Decrease)/increase of net income                       |                                | (89 )                      |                            | 196   | 107   |
| (Decrease)/increase of basic earnings per share (RMB)   |                                | (0.007 )                   |                            | 0.016   | 0.009 |
| (Decrease)/increase of diluted earnings per share (RMB) |                                | (0.007 )                   |                            | 0.016   | 0.009 |

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The following table disclosed the effects on net income in the consolidated statements of income for the year ended December 31, 2005 that would have occurred had the previous accounting policies been applied in the year 2005.

| RMB in millions<br>(except per share data)              | Effect of new policies in 2005 |                            |                            | Change in accounting policy for revenue recognition<br>(Note 2.2 (d)) | Total |
|---|--------------------------------|----------------------------|----------------------------|---|-------|
|   | HKAS 17<br>(Notes 2.2 (a))     | HKFRS 2<br>(Notes 2.2 (b)) | HKAS 38<br>(Notes 2.2 (c)) |   |       |
| (Decrease)/increase of net income                       |                                | (108 )                     | 171                        | 178   | 241   |
| (Decrease)/increase of basic earnings per share (RMB)   |                                | (0.009 )                   | 0.014                      | 0.014   | 0.019 |
| (Decrease)/increase of diluted earnings per share (RMB) |                                | (0.009 )                   | 0.014                      | 0.014   | 0.019 |

(a) The adoption of revised HKAS 17 resulted in:

|   | December 31, 2004<br>RMB in millions | December 31, 2005<br>RMB in millions |
|---|--------------------------------------|--------------------------------------|
| Decrease in property, plant and equipment | (412 )                               | (697 )                               |
| Increase in other assets                  | 412                                  | 697                                  |

|  | 2003<br>RMB in millions | 2004<br>RMB in millions | 2005<br>RMB in millions |
|--|-------------------------|-------------------------|-------------------------|
| Decrease in depreciation and amortization              | (27 )                   | (26 )                   | (28 )                   |
| Increase in general, administrative and other expenses | 27                      | 26                      | 28                      |

(b) The adoption of HKFRS 2 resulted in:

|   | December 31, 2004<br>RMB in millions | December 31, 2005<br>RMB in millions |
|---|--------------------------------------|--------------------------------------|
| Increase in employee share-based compensation reserve | 111                                  | 215                                  |
| Increase in share premium                             |                                      | 4                                    |
| Decrease in retained earnings                         | (22 )                                | (111 )                               |

|  | 2003<br>RMB in millions | 2004<br>RMB in millions | 2005<br>RMB in millions |
|--|-------------------------|-------------------------|-------------------------|
| Increase in employee benefit expenses        | 22                      | 89                      | 108                     |
| Decrease in basic earnings per share (RMB)   | 0.002                   | 0.007                   | 0.009                   |
| Decrease in diluted earnings per share (RMB) | 0.002                   | 0.007                   | 0.009                   |



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(c) The following tables disclosed the effects on the relevant line items in the consolidated financial statements for the year ended December 31, 2005 as compared to what would have occurred had the previous accounting policy for goodwill been applied in 2005.

|                               | <b>December 31, 2005</b><br><b>RMB in millions</b> |
|-------------------------------|--|
| Impact on goodwill - increase | 178  |
| Increase in retained earnings | 7  |

|  | <b>2005</b><br><b>RMB in millions</b> |
|--|---------------------------------------|
| Impact on depreciation and amortization (decrease) | 171                                   |
| Increase in basic earnings per share (RMB)         | 0.014                                 |
| Increase in diluted earnings per share (RMB)       | 0.014                                 |

(d) Changes in accounting policy for recognition of upfront non-refundable revenue and direct incremental costs resulted in:

|                                 | <b>December 31, 2004</b><br><b>RMB in millions</b> | <b>December 31, 2005</b><br><b>RMB in millions</b> |
|---------------------------------|--|--|
| Increase in other assets        | 3,546  | 3,192  |
| Decrease in deferred tax assets | (74 )  | (34 )  |
| Increase in deferred revenue    | 3,840  | 3,348  |
| Decrease in retained earnings   | (564 )   | (368 )   |

|  | <b>2003</b><br><b>RMB in millions</b> | <b>2004</b><br><b>RMB in millions</b> | <b>2005</b><br><b>RMB in millions</b> |
|--|---------------------------------------|---------------------------------------|---------------------------------------|
| (Decrease)/increase in revenue                       | (482 )                                | (244 )                                | 492                                   |
| Increase in selling and marketing expenses           | 107                                   | 579                                   | 1,140                                 |
| Decrease in costs of telecommunication products sold | 713                                   | 917                                   | 786                                   |
| (Increase)/decrease in income tax expenses           | (41 )                                 | 102                                   | 40                                    |
| Increase in basic earnings per share (RMB)           | 0.007                                 | 0.016                                 | 0.014                                 |
| Increase in diluted earnings per share (RMB)         | 0.007                                 | 0.016                                 | 0.014                                 |

The Group has not early adopted the following new Standards or Interpretations that have been issued but are not yet effective. The Group has commenced an assessment of the impact of these new standards and interpretations but is not yet in a position to state whether these new standards and interpretations would have a significant impact on the Group's consolidated financial statements.

HKAS 19 (Amendment)  
HKFRS 7  
HKFRS-Int 4  
HKFRS-Int 5

Actuarial Gains and Losses, Group Plans and Disclosures  
Financial Instruments: Disclosures  
Determining whether an Arrangement contains a lease  
Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds

## 2.3 Consolidation

The consolidated financial statements include the financial statements of the Company and its subsidiaries made up to December 31.

Subsidiaries are those entities in which the Company, directly or indirectly, controls the composition of the board of directors, controls more than half the voting power or holds more than half of the issued share capital.

Subsidiaries are fully consolidated from the date on which control is transferred to the Group. They are de-consolidated from the date that control ceases.

The purchase method of accounting is used to account for the acquisition of subsidiaries by the Group. The cost of an acquisition is measured at the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date, irrespective of the extent of any minority interest. The excess of the cost of acquisition over the fair value of the Group's share of the identifiable net assets acquired is recorded as goodwill. If the cost of acquisition is less than the fair value of the net assets of the subsidiary acquired, the difference is recognized directly in the statements of income (Note 2.2).

Inter-company transactions, balances and unrealized gains on transactions between group companies are eliminated. Unrealized losses are also eliminated unless the transaction provides evidence of an impairment of the asset transferred. Accounting policies of subsidiaries have been changed where necessary to ensure consistency with the policies adopted by the Group.

Minority interests at the balance sheet date, being the portion of the net assets of subsidiaries attributable to equity interests that are not owned by the Company, whether directly or indirectly through subsidiaries, are presented in the consolidated balance sheets and statements of changes in equity within equity, separately from equity attributable to the equity shareholders of the Company. Minority interests in the results of the Group are presented on the face of the consolidated statements of income as an allocation of the total profit or loss for the year between minority interests and the equity shareholders of the Company.

Where losses applicable to the minority exceed the minority's interest in the equity of a subsidiary, the excess, and any further losses applicable to the minority, are charged against the Group's interest except to the extent that the minority has a binding obligation to, and is able to, make additional investment to cover the losses. If the subsidiary subsequently reports profits, the Group's interest is allocated all such profits until the minority's share of losses previously absorbed by the Group has been recovered.

In the Company's balance sheets the investments in subsidiaries are stated at cost less provision for impairment losses. The results of subsidiaries are accounted for by the Company on the basis of dividends received and receivable.

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## 2.4 Segment Reporting

A business segment is a group of assets and operations engaged in providing products or services that are subject to risks and returns that are different from those of other business segments. The Group has not presented geographical segment. This is also consistent with the Group's internal financial reporting.

Unallocated costs primarily represent corporate expenses and income taxes. Segments assets consist primarily of property, plant and equipment, other assets, prepayments, inventories, receivables and operating cash. Segment liabilities comprise operating liabilities. Capital expenditure mainly comprises additions to property, plant and equipment.

## 2.5 Foreign Currency Translation

### (a) Functional and presentation currency

Items included in the financial statements of the Group's entities are measured using the currency of the primary economic environment in which the entities operate (the functional currency). The consolidated financial statements are presented in Renminbi (RMB), which is the Company's functional and presentation currency.

### (b) Transactions and balances

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognized in the statements of income.

For the convenience of the reader, translation of amounts for RMB into United States dollars (US\$) has been made at the noon buying rate in New York city for cable transfer payables in foreign currencies as certified for customers purposes by the Federal Reserve Bank of New York on December 30, 2005 of US\$1.00=RMB8.0702. No representation is made that RMB amounts could have been, or could be, converted into US\$ at that rate on December 31, 2005, or at other rate.

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## 2.6 Property, Plant and Equipment

### (a) Buildings

Buildings are stated at valuation. Independent valuations are performed periodically with the last valuation performed on March 31, 2000. In the intervening years, the directors review the carrying value of buildings and adjustment is made where in the directors' opinion there has been a material change in value. Any increase in buildings valuation is credited to the revaluation reserve; any decrease is first offset against the increase on earlier valuations recorded in the revaluation reserve, in respect of the same property and is thereafter charged to the statements of income. Upon the disposal of revalued buildings, the realized portion of the revaluation reserve is transferred from the valuation reserve to retained earnings.

### (b) Other property, plant and equipment

Other property, plant and equipment, comprising leasehold improvements, plant, telecommunications equipment, office furniture and fixtures are stated at cost less accumulated depreciation and accumulated impairment losses. The cost of an asset comprises its purchase price and any directly attributable costs of bringing the asset to its working condition and location for its intended use. Expenditures incurred after the property, plant and equipment have been put into operation, such as repairs and maintenance and overhaul costs, are normally charged to expense in the year in which they are incurred. In situations where it can be clearly demonstrated that the expenditure has resulted in an increase in the future economic benefits expected to be obtained from the use of the asset beyond its originally assessed standard of performance, the expenditure is capitalized as an additional cost of the assets.

### (c) Depreciation

Depreciation of property, plant and equipment is calculated using the straight-line method to allocate cost or revalued amounts to their residual values over their estimated useful lives, as follows:

|                                       | Depreciable life | Residual value |   |
|---------------------------------------|------------------|----------------|---|
| Buildings                             | 8-40 years       | 3              | % |
| Telecommunications equipment          | 3-15 years       | 3              | % |
| Office furniture, fixtures and others | 4-14 years       | 3              | % |

Leasehold improvements are depreciated over the shorter of their estimated useful lives or the lease periods.

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

An asset's carrying amount is written down immediately to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount (Note 2.9).

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(d) Construction-in-progress

Construction-in-progress represents buildings, plant and equipment under construction and pending installation, and is stated at cost less accumulated impairment losses. Costs include construction and acquisition costs, and interest charges arising from borrowings used to finance the assets during the construction period.

No provision for depreciation is made on construction-in-progress until such time when the assets are completed and ready for use.

(e) Gain or loss on disposal

The gain or loss on disposal of a property, plant and equipment is the difference between the net sales proceed and the carrying amount of the relevant asset, and is recognized in the statements of income. Any revaluation reserve balance remaining attributable to the relevant asset is transferred to retained earnings and is shown as a movement in reserves.

## 2.7 Goodwill/Negative Goodwill

In 2003 and 2004, goodwill represented the excess of purchase consideration over the fair values of the Group's share of the net identifiable assets and liabilities of the acquired subsidiary/associated company at the date of acquisition. Prior to the adoption of HKFRS 3 on January 1, 2005, goodwill was carried at cost less accumulated amortization and accumulated impairment losses. Goodwill was amortized using the straight-line method over the estimated economic lives of the acquired businesses. Goodwill arising on major strategic acquisitions of the Group to expand its geographical market coverage was amortized over 20 years.

Negative goodwill represented the excess of the fair values of the Group's share of the net identifiable assets and liabilities of the acquired subsidiary over the purchase consideration at the date of acquisition. Negative goodwill was recognized using the straight-line method over the remaining weighted average useful life of acquired identifiable on-monetary assets.

The adoption of HKFRS 3, HKAS 36 and HKAS 38 resulted in a change in the accounting policy for goodwill/negative goodwill. Effective from January 1, 2005, the Group ceased amortization of goodwill, and the accumulated amortization as of December 31, 2004 has been eliminated with a corresponding decrease in the cost of goodwill. Goodwill is tested annually for impairment, as well as when there is indication of impairment.

In addition, in accordance with HKFRS 3, from January 1, 2005, if the fair value of the net identifiable assets and liabilities acquired exceed the purchase consideration (i.e. an amount arises which would have been known as negative goodwill under the previous accounting policy), the excess is recognized immediately in the consolidated statements of income as it arises. Negative goodwill previously recognized has been derecognized at January 1, 2005, with a corresponding adjustment to the opening balance of retained earnings of the Group (Note 2.2).

Goodwill is allocated to cash-generating units for the purpose of impairment testing.

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## 2.8 Other Assets

Other assets mainly represent (i) capitalized direct incremental costs for activating GSM and CDMA subscribers; (ii) capitalized customer acquisition costs under contractual CDMA subscriber packages; (iii) computer software; (iv) prepaid rentals and leased lines; and (v) prepayment for lease of land.

Capitalized direct incremental costs for activating GSM and CDMA subscribers, including costs of SIM/UIM cards and commissions which are directly associated with upfront non-refundable revenue received upon activation of cellular services, are amortized over the expected customer service periods (Note 2.2). The expected customer service periods are estimated based on the expected stabilized churn rates of subscribers.

Capitalized customer acquisition costs under contractual CDMA subscriber packages represent the cost of CDMA handsets given to contractual subscribers under special promotional packages. Such customer acquisition costs, to the extent recoverable, are amortized over the contractual period (not exceeding 2 years) during which the minimum contract revenue is expected to flow to the Group. Customer acquisition costs of contractual CDMA subscribers are included in prepayment and other current assets when the customer contract is within 1 year of expiry, whereas they are recorded as other assets when the contract period is over 1 year.

Acquired computer software licences are capitalized on the basis of the costs incurred to acquire and bring to use the specific software. These costs are amortized over their estimated useful lives.

Long-term prepaid leased lines and rentals are amortized using a straight-line method over the lease period.

Long-term prepayment for lease of land are amortized over the period of the lease on a straight-line basis (Note 2.2).

## 2.9 Impairment of Assets

Assets that have an indefinite useful life are not subject to amortization, but are tested at least annually for impairment and are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. Assets that are subject to amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognized for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating units).

## 2.10 Inventories

Inventories, which principally comprise handsets, SIM cards, UIM cards and accessories, are stated at the lower of cost and net realizable value. Cost is based on the weighted average method and comprises all costs of purchase and other costs incurred in bringing the inventories to their present location and condition. Net realizable value is determined on the basis of anticipated sales proceeds less estimated selling expenses.

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## **2.11 Accounts Receivable and Other Receivables**

Accounts receivable and other receivables are recognized at fair value, less provision for impairment. A provision for impairment of accounts receivable and other receivables is established when there is objective evidence that the Group will not be able to collect all amounts due according to the original terms of the receivables. The amount of the provision is recognized in the statements of income.

## **2.12 Short-term Bank Deposits**

Short-term bank deposits are cash invested in fixed-term deposits with original maturities ranging from more than 3 months to 1 year.

## **2.13 Cash and Cash Equivalents**

Cash and cash equivalents are carried at cost in the balance sheets. Cash and cash equivalents include cash on hand, deposits held at call with banks and other short-term highly liquid investments with original maturities of three months or less.

## **2.14 Deferred Revenue**

### **(a) Advances from Customers**

Advances from customers are amounts paid by customers for GSM and CDMA prepaid cards, GSM and CDMA prepaid service fees, Internet protocol ( IP ) telephone cards and other calling cards which cover future telecommunications services (over a period of 1 to 12 months). Customer advances are stated at the amount of proceeds received less the amount already recognized as revenues upon the rendering of services.

### **(b) Deferred revenue**

Upfront non-refundable revenue, including connection fee and receipts from activation of SIM/UIM cards relating to GSM and CDMA businesses, are deferred and recognized over the expected service period.

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## 2.15 Employee Benefits

### (a) Retirement benefits

The Group's contributions to the defined contribution retirement scheme are expensed as incurred, and for the contributions to the supplementary defined contribution retirement scheme, they are reduced by contributions forfeited by those employees who leave the scheme prior to vesting fully in the contributions.

### (b) Housing benefits

The Group's contributions to the housing fund, special monetary housing benefits and other housing benefits are expensed as incurred.

### (c) Share-based compensation cost

The Group operates an equity-settled, share-based compensation plan. The fair value of the employee services received in exchange for the grant of the options is recognized as an expense. The total amount to be expensed over the vesting period is determined by reference to the fair value of the options granted. At each balance sheet date, the entity revises its estimates of the number of options that are expected to become exercisable. The Group recognizes the impact of the revision of original estimates, if any, in the statements of income, and a corresponding adjustment to equity over the remaining vesting period (Note 2.2).

The proceeds received net of any directly attributable transaction costs are credited to share capital (nominal value) and share premium when the options are exercised.

## 2.16 Provisions

Provisions are recognized when the Group has present obligations (legal or constructive) as a result of past events, it is probable (i.e. more likely than not) that an outflow of resources will be required to settle the obligation, and the amount has been reliably estimated. Provisions are reviewed at each balance sheet date and adjusted to reflect the current best estimate. Where the effect of the time value of money is material, the amount of a provision is the present value of the expenditures expected to be required to settle the obligation.

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## 2.17 Revenue Recognition

(a) Revenue is recognized when it is probable that the economic benefits associated with a transaction will flow to the Group and when the revenue and cost can be measured reliably, on the following basis:

- Usage fees are recognized when the service is rendered;
- Monthly fees are recognized as revenue in the month during which the services are rendered;
- Revenue from telephone cards, which represent prepaid service fees received from customers for telephone services, is recognized when the related service is rendered upon actual usage of the telephone cards by customers;
- Leased lines and indefeasible rights of use ( IRU ) are treated as operating leases with rental income recognized on a straight-line basis over the lease term, except for the lease of specific and identified network assets that transfer substantially all the risks and rewards incidental to the ownership to the lessee, which is recognized as capacity sales;
- Sales of telecommunications products, such as handsets, pagers and accessories etc, are recognized when title has been passed to the customers; and
- Upfront non-refundable revenue, including connection fee and receipts from activation of SIM/UIM cards related to GSM and CDMA businesses, are capitalized and recognized over the expected service periods which are estimated based on the expected stabilized churn rates of subscribers (Note 2.2).

Revenue is stated net of business tax and government surcharges.

### (b) Interest income

Interest income from deposits in banks or other financial institutions is recognized on a time proportion basis, using the effective interest method.

### (c) Dividend income

Dividend income is recognized when the rights to receive payment are established.

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## 2.18 Leases (as the lessee)

### (a) Operating lease

Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating leases (net of any incentives received from the lessor) are expensed in the statements of income on a straight-line basis over the period of the lease.

### (b) Finance lease

Leases of assets where the Group has substantially all the risks and rewards of ownership are classified as finance leases. Finance leases are capitalized at the lease's commencement at the lower of the fair value of the leased property and the present value of the minimum lease payments. Each lease payment is allocated between the liability and finance charges so as to achieve a constant rate on the finance balance outstanding. The corresponding rental obligations, net of finance charges, are included in current and non-current borrowings. The interest element of the finance cost is recorded in the statements of income over the lease period so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period.

## 2.19 Costs under Subscriber Point Reward Program

Under the subscriber point reward program, the estimated costs of providing telecommunications services or providing non-cash gifts are calculated based on the value of bonus points awarded to subscribers, which are recorded as selling and marketing expenses and accrued as a current liability when subscribers accumulate bonus points.

## 2.20 Borrowing Costs

Borrowing costs are expensed as incurred, except for interest directly attributable to the acquisition, construction or production of an asset, that necessarily takes a substantial period of time to get ready for its intended use, in which case they are capitalized as part of the cost of that asset. Capitalization of borrowing costs commences when expenditures for the asset and borrowing costs are being incurred and the activities to prepare the asset for its intended use are in progress. Borrowing costs are capitalized up to the date when the project is completed and ready for its intended use.

To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization is determined at the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings.

To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization is determined by applying a capitalization rate to the expenditures on that asset. The capitalization rate is the weighted average of the borrowing costs applicable to the borrowings of the Group that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalized during a period should not exceed the amount of borrowing cost incurred during that period. Other borrowing costs are recorded as expenses when incurred.

The capitalized borrowing rate represents the cost of capital for raising the related borrowings externally and varies from 3.60% to 5.58% for the year ended 31 December 2005 (2003: 4.44% to 5.76%; 2004: 4.78% to 5.73%).



## 2.21 Taxation

### (a) Income tax

Income tax is provided on the basis of income for statutory financial reporting purposes, adjusted for income and expense items, which are not assessable or deductible for tax purposes.

### (b) Deferred income tax

Deferred income tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. However, if the deferred income tax arises from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable income or loss, it is not accounted for. Deferred income tax is determined using tax rates (and laws) that have been enacted or substantially enacted by the balance sheet date and are expected to apply when the related deferred income tax asset is realized or the deferred income tax liability is settled.

Deferred income tax assets are recognized to the extent that it is probable that future taxable income will be available against which the temporary differences can be utilized.

## 2.22 Dividend Distribution

Dividend distribution to the Company's shareholders is recognized as a liability in the Group's financial statements in the period in which the dividends are approved by the Company's shareholders.

## 2.23 Related Parties

Entities are considered to be related if one has the ability to control the other, directly or indirectly, or has the ability to exercise significant influence over the financial and operating decisions of the other. Entities are also considered to be related if they are subject to common control or common significant influence.

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## 2.24 Investments

In 2003, the Group classified its investments in securities, other than subsidiaries, as non-trading securities and trading securities.

### (a) Non-trading securities

Investments which were held for non-trading purpose were stated at fair value at the balance sheet date. Changes in the fair value of individual securities were credited or debited to the investment revaluation reserve until the security was sold, or was determined to be impaired. Upon disposal, the cumulative gain or loss representing the difference between the net sales proceeds and the carrying amount of the relevant security, together with any surplus/deficit transferred from the investment revaluation reserve, was dealt with in the statements of income.

Where there was objective evidence that individual investments were impaired the cumulative loss recorded in the revaluation reserve was taken to the statements of income.

### (b) Trading securities

Trading securities were carried at fair value. At each balance sheet date, the net unrealized gains or losses arising from the changes in fair value of trading securities were recognized in the statements of income. Incomes or losses on disposal of trading securities, representing the difference between the net sales proceeds and the carrying amounts, were recognized in the statements of income as they arose.

Upon the sale of New Guoxin on December 31, 2003, there was no investment held by the Group for 2004 and 2005.

## 2.25 Contingent Liabilities and Contingent Assets

A contingent liability is a possible obligation that arises from past events and whose existence will only be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the Group. It can also be a present obligation arising from past events that is not recorded because it is not probable that outflow of economic resources will be required or the amount of obligation cannot be measured reliably.

A contingent liability is not recognized but is disclosed in the notes to the financial statements. When a change in the probability of an outflow occurs so that outflow is probable, the liability will then be recorded as a provision.

A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain events not wholly within the control of the Group.

Contingent assets are not recognized but are disclosed in the notes to the financial statements when an inflow of economic benefits is probable. When an inflow is virtually certain, an asset is recognized.

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## 2.26 Earnings per Share and per American Depository Share ( ADS )

Basic earnings per share is computed by dividing the income attributable to shareholders by the number of weighted average number of ordinary shares outstanding during the year.

Diluted earnings per share is computed by dividing the income attributable to shareholders by the weighted average number of ordinary shares, after adjusting for the effects of the dilutive potential ordinary shares.

Basic and diluted net earnings per ADS have been computed by multiplying the net income per share by 10, which is the number of shares represented by each ADS.

## 3. FINANCIAL RISK MANAGEMENT

The Group's activities are exposed to a variety of financial risks: market risk (including currency risk and fair value interest risk), credit risk, liquidity risk and cash flow interest-rate risk. The Group's overall risk management program focuses on the unpredictability of financial markets and seeks to minimize potential adverse effects on the Group's financial performance.

Risk management is carried out by the Group's finance department, following the overall directions determined by the Board of Directors. The finance department identifies and evaluates financial risks in close co-operation with the Group's operating units.

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(a) Market risk - Foreign exchange risk

The Group's businesses are mainly conducted in RMB, except the Company and certain subsidiaries located in HK, Macau and USA. Dividends to shareholders are declared in RMB and paid in HK dollars. The Group is exposed to foreign exchange risk arising from various currency exposures, primarily with respect to US dollar and HK dollar. As of December 31, 2005, approximately RMB11,406 million of loans and RMB1,001 million of bank balances and cash and short-term bank deposits are denominated in US dollar and HK dollar (2004: RMB10,629 million of loans and RMB782 million of bank balances and cash and short-term bank deposits). The Group has not used any forward contracts or foreign currency swap arrangements to hedge its exposure to foreign currency risk. However, the Group's treasury department in headquarter continuously monitors the foreign exchange risk regarding foreign currency loans and deposits.

(b) Credit risk

The Group has no significant concentrations of credit risk. The extent of the Group's credit exposure is represented by the aggregate balance of accounts receivable for services and amounts due from related parties and other operators.

The Group has policies that limit the amount of credit exposure to accounts receivable for services and amounts due from related parties and other operators. The normal credit period granted by the Group is an average 30 days from the date of invoice. The Group believes that adequate provision for uncollectible accounts receivable have been made.

(c) Liquidity risk

Prudent liquidity risk management implies maintaining sufficient cash and the availability of funding through an adequate amount of committed credit facilities. Due to the dynamic nature of the underlying businesses, the Group's finance department aims to maintain flexibility in funding by keeping committed credit lines available.

(d) Cash flow and fair value interest rate risk

The Group's interest-bearing assets are mainly represented by bank deposits. Apart from this, the Group's income and operating cash flows are substantially independent of changes in market interest rates.

The Group's interest-rate risk arises from long-term bank loans. Bank loans issued at floating rates expose the Group to cash flow interest-rate risk. Bank loans and short-term bonds issued at fixed rates expose the Group to fair value interest-rate risk. As of December 31, 2005, approximately RMB7,442 million of long-term loans (2004: approximately RMB27,292 million), RMB5,303 million (2004: approximately RMB8,231 million) of short-term loans and RMB9,866 million (2004: Nil) of short-term bonds were at fixed rates, while approximately RMB9,684 million (2004: approximately RMB9,932 million) of long-term loans and RMB1,722 million (2004: approximately RMB697 million) of short-term loans were at floating rates.

The Group does not expect any significant changes in interest rates which might materially affect the Group's results of operations.

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#### 4. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS

Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

The Group makes estimates and assumptions concerning the future. The resulting accounting estimates will, by definition, seldom equal the related actual results. The estimates and assumptions that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are discussed below.

##### 4.1 Accounting Estimates

###### (a) Depreciation of property, plant and equipment

Depreciation of the Group's property, plant and equipment is calculated using the straight-line method to allocate cost or revalued amounts to residual values over the estimated useful lives. The Group reviews the useful lives and residual values periodically to ensure that the method and rates of depreciation are consistent with the expected pattern of realization of economic benefits from property, plant and equipment. The Group uses estimates of useful lives of property, plant and equipment based on historical experience, taking into account anticipated technological changes. If there are significant changes from previously estimated useful lives, the amount of depreciation expense may change. The cost and accumulated depreciation of property, plant and equipment as of December 31, 2005 amounted to RMB190.9 billion (2004: RMB173.8 billion) and RMB74.8 billion (2004: RMB55.3 billion), respectively.

###### (b) Impairment of non-current assets

The Group tests whether non-current assets have suffered from any impairment, in accordance with the accounting policy stated on Note 2.9. The recoverable amount of an asset is the higher of its fair value less costs to sell and its value in use. Management estimates value in use based on estimated discounted future cash flows of the cash generating unit at the lowest level to which the asset belongs. If there is a significant change in management's assumptions and the estimated recoverable amounts of the non-current assets, the Group's future results would be affected.

In 2003, the Group has recorded an impairment loss for property, plant and equipment of the Guoxin Paging assets amounted to approximately RMB528 million as of June 30, 2003, based on their estimation of the discounted future net cash flows expected to arise from the continuing operations of the Paging business. Subsequently, the Group sold the paging business to Unicom Group on December 31, 2003, and recognized a disposal loss (difference between the sales proceeds and the carrying amount of the net assets of the paging business as of the effective date of the disposal) of approximately RMB663 million to the statement of income in 2003.

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(c) Provision for Doubtful Debts

Accounts receivables are stated at costs, less provision for doubtful debts. The Group evaluates specific accounts receivable where there are indications that the receivable may be doubtful or is not collectible. The Group records a provision based on its best estimates to reduce the receivable balance to the amount that is expected to be collected. For the remaining receivable balances as of each period-end, the Group makes a provision based on observable data indicating that there is a measurable decrease in the estimated future cash flows from the remaining balances. The Group makes such estimates based on its past experience, historical collection patterns, subscribers' credit worthiness and collection trends. For the general subscribers of Cellular, Long Distance, Data and Internet services, the Group makes a full provision for receivables aged over 3 months, which is consistent with its credit policy with respect to relevant subscribers.

The Group's estimates described above are based on historical experience, subscriber creditability and collection trends. If circumstances change (e.g. due to factors including developments in the Group's business and the external market environment), the Group may need to re-evaluate its policies on doubtful debts, and make additional provisions in the future.

(d) Provision for Subscriber Point Reward Program

The Group has implemented a subscriber Point Reward Program since 2004, which is a bonus point based scheme that rewards subscribers according to their service consumption, loyalty and payment history. The estimated liability is recognized based on (i) the value of each bonus point awarded to subscribers, (ii) the number of bonus points related to subscribers who are qualified to exercise their redemption right at period/year end, and (iii) the estimated number of bonus points related to subscribers who have no right to redeem the incentives at period/year end, but who are expected to ultimately earn and claim awards under the Reward Program. If subscribers redeem rewards or their entitlements expire, the provision is adjusted accordingly. The Group has recognized the liability amounting to RMB337 million as of December 31, 2005 (2003: Nil; 2004: RMB40 million). As the Group has not had much historical incentive redemption experience in the past, the Group may need to re-assess estimates for accruing for the potential bonus point liability when there is a more stabilized and reliable historical redemption rate in future.

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(e) Income Tax and Deferred Taxation

Income tax is provided based on income before tax for statutory financial reporting purposes, adjusted for income and expense items that are not assessable or deductible for tax purposes and taking into consideration any preferential tax treatment to which the Group is entitled.

Deferred taxation is provided in full, using the liability method, on temporary differences arising between the tax basis of assets and liabilities and their carrying amounts in the financial statements. Deferred tax assets are recognized to the extent that it is probable that future taxable income will be available against which the temporary differences can be utilized.

In the preparation of the financial statements, the Group estimated its income tax provision and deferred taxation in accordance with the prevailing tax rules and regulations, taking into account any special approvals obtained from relevant tax authorities and any preferential tax treatment to which it is entitled in each location or jurisdiction in which the Group operates. This process involves estimation made by the Group about its current tax exposure together with an assessment of temporary differences resulting from different treatment of items for tax and accounting purposes in order to determine the amount of tax provisions for the period. The Group believes that it has recorded adequate tax provisions based on its best estimates and assumptions. For the evaluation of temporary differences, the Group has assessed the likelihood that the deferred taxes could be recovered. Major deferred tax components relate to interest on loans from China-China-Foreign ( CCF ) joint ventures, loss arising from terminations of CCF arrangements (Note 9(f)), provisions for doubtful debts and write-down of inventory to net realizable value and additional depreciation deductible for tax purposes. Due to the effects of these temporary differences on income tax, the Group has recorded deferred tax assets amounting to RMB335 million as of December 31, 2005 (2004: RMB469 million). Deferred tax assets are recognized based on the Group's estimates and assumptions that they will be recovered from taxable income arising from the continuing operations in the foreseeable future.

The Group believes it has recorded adequate current and deferred taxes based on prevailing tax rules and regulations and its current best estimates and assumptions. In the event that future tax rules and regulations or related circumstances change, adjustments to current and deferred taxes may be necessary.

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## 4.2 Accounting judgements

### (a) Capitalization of CDMA Customer Acquisition Costs

The Group has been operating the CDMA business since the beginning of 2002. In order to accelerate the development of the CDMA business and subscriber growth, the Group began to offer certain promotional packages in the second half of 2002. As part of the contractual arrangements with certain CDMA contractual subscribers under these special promotional packages, CDMA handsets were provided to the subscribers for their use at no additional charge during the specified contract periods, which range from 6 months to 2 years. In return, the subscribers are required to incur a minimum amount of service fees during the contract period. If the contractual subscribers can fulfill the minimum contract spending amounts by the end of the contract period, they will not be obliged to repay the remaining costs of the CDMA handsets given for their use. In addition, to secure contract performance, these subscribers are required under their contracts to (1) prepay certain amounts of service fees or deposits, (2) maintain a bank deposit in one of the designated commercial banks to secure their minimum contract amounts, or (3) provide a guarantor who will compensate the Group for any loss in the event of the subscriber's non-performance of related contractual obligations.

The Group considers the costs of the CDMA handsets provided to contractual subscribers under these promotional packages as customer acquisition costs for the development of these new CDMA contractual subscribers. Such customer acquisition costs are capitalized to the extent expected to be recoverable, and amortized over the contractual periods (not exceeding two years), over which future economic benefits are expected to flow to the Group in the form of minimum contract revenue (Note 8 and 12).

The Group determined its accounting policy for capitalization of customer acquisition costs of contractual CDMA subscribers after a careful evaluation of specific facts and circumstances, and believes that the capitalization of such costs is appropriate because future economic benefits are expected to flow to the Group in the form of future contractual revenues, taking into consideration (1) the historically high ARPUs and low churn rate, default or bad debt rates of these subscribers; (2) the Group's established procedures in and the relative low cost of enforcement of contracts in default; and (3) the existence of specified contract periods with minimum contract spending amounts and built-in contractual safeguarding measures such as non-refundable prepayments, bank deposits, and guarantees received, as well as penalty clauses imposed on subscribers.

Therefore, the Group believes that the capitalized customer acquisition costs are recoverable from future revenue to be derived from these promotional packages, and the capitalization and amortization of these customer acquisition costs is an appropriate accounting policy. Furthermore, the Group continuously assesses and evaluates the recoverability of these customer acquisition costs, based on detailed review of historical subscriber churn rates and estimated default rates. Based on the Group's current assessment and evaluation, the Group believes that there is no significant problem in recovering the carrying amounts of the customer acquisition costs as of December 31, 2003, 2004 and 2005.

The Group has made the above recoverability assessments based on the current legal and operating environment relating to the subscribers contract performance and other information currently available. Actual results may differ significantly from the current situation and the Group's current estimates. If the situation changes significantly in the future, the Group may need to accelerate the amortization of customer acquisition costs based on conditions at that time.

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(b) Lease of CDMA Network Capacity

(i) Original CDMA lease agreements

A CDMA network capacity lease agreement has been signed by the Group and Unicom Group's wholly-owned subsidiary, Unicom New Horizon Mobile Telecommunications Company Limited (Unicom New Horizon). Pursuant to this CDMA lease agreement, Unicom New Horizon has agreed to lease the capacity of the CDMA network to the Group covering the 9 provinces of Guangdong, Jiangsu, Zhejiang, Fujian, Liaoning, Shandong, Anhui, Hebei, Hubei and the 3 municipalities of Beijing, Shanghai and Tianjin. This lease became effective on 8 January 2002.

In addition, on December 31, 2002 and 2003, the Group acquired all the equity interests in Unicom New Century and Unicom New World, respectively, which together operate GSM and CDMA Cellular Businesses in another 12 provinces, 1 municipality and 5 autonomous regions in the PRC. Unicom New Century and Unicom New World have also respectively entered into a CDMA lease agreement with Unicom Group and Unicom New Horizon on similar terms and conditions. These lease agreements and the Group's existing lease agreement will be referred to as the Original CDMA Lease Agreements.

According to the terms of the Original CDMA Lease Agreements, the initial lease period is for one year, renewable for additional one-year term at the Group's option. The Group has the exclusive right to lease and operate the CDMA network capacity in the above regions. Also, the Group has the option to add or reduce the capacity leased by giving specified period of advance notice. The lease fee per unit of capacity is calculated on a basis that if full capacity is leased, it would permit Unicom New Horizon to recover its investment in constructing the CDMA network in 7 years, together with an internal return of 8%. In January 2004, the Group renewed the CDMA network capacity for an additional one-year term. The Group has the option to purchase the network assets based on the appraised value of the network determined by an independent appraiser.

The appropriate lease classification at the inception of the Original CDMA Lease Agreement was assessed. Factors and related implications considered include whether the Group has taken the risks and rewards of ownership of the CDMA assets. Furthermore, the Group has considered whether the existence of the purchase option and the annual renewal options, combined with the related economic penalties, risks and benefits, have caused the Group to take on risks and rewards similar to those that an owner of these assets would bear.

Unicom New Horizon has the legal ownership of the CDMA network, is directly responsible for the planning, financing and construction of the CDMA network, and directly enters into all contracts with suppliers and constructors. The Group believes it only bears the risks associated with the operation of the CDMA business during the relevant leasing periods and are free from any ownership risks of the CDMA network. According to the terms of the Original CDMA Lease Agreements, the initial lease period was only one year, with renewal of additional one-year terms at the Group's option. Accordingly, there was no predetermined lease period and minimum network capacity to be leased in future periods. The Group has the option to determine whether they will renew and continue the leases and how much capacity to lease. The Group also has the option to decide whether they will exercise the purchase option for the CDMA network at fair value based on the then market environment and future operating performance of the CDMA business subject to approvals obtained from the Company's independent minority shareholders.

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Accordingly, if the CDMA business turns out to be unsuccessful, the Group does not have the obligation to continue this CDMA lease arrangement or to exercise the purchase option.

In general, the classification of leases is dependent on whether the risks and rewards of ownership of the leased assets rest substantially with the lessor or the lessee. Leases that substantially transfer to the lessee all the risks and rewards of ownership of the leased assets are accounted for as finance leases; and leases where substantially all the risks and rewards of ownership of the leased assets remain with the lessor are accounted for as operating leases. When performing this assessment, the Group has considered a number of factors as stated above that required significant judgments.

At the inception of the Original CDMA Lease Agreements, there was a high degree of uncertainty related to the market condition and operating results of the CDMA business. It was highly uncertain whether the Group would continue to lease the network in the future or to estimate the future network capacity to be leased. The Group was also unable to determine whether or not they would exercise the purchase option. Given these uncertainties and due to the fact that the risks associated with the ownership of the CDMA assets substantially remained with Unicom Group and Unicom New Horizon, the Group accounted for the leasing of the CDMA network as operating leases for the initial lease periods, estimated to be three years, so as to reflect the respective rights and obligations of the relevant parties to the Original CDMA Lease Agreements.

(ii) New CDMA lease agreement

On March 24, 2005, the Group entered into a new CDMA lease agreement (the New CDMA Lease Agreement ) with Unicom Group and Unicom New Horizon to replace the Original CDMA Lease Agreements. Pursuant to the New CDMA Lease Agreement, the CDMA lease has an initial term of two years, the lease fee of the CDMA network shall be determined on the basis of the CUCL's CDMA services revenue, details as follows:

- In 2005, the lease fee shall be 29% of the audited CDMA service revenue of the lessee for that year, but shall not be less than 90% of the total amount of lease fee paid by the Group to Unicom New Horizon pursuant to the old lease agreement for 2004; and
- In 2006, the lease fee shall be 30% of the audited CDMA service revenue of the lessee for that year, but shall not be less than 90% of the total amount of lease fee paid by the Group to Unicom New Horizon pursuant to the New CDMA Lease Agreement for 2005.

The major modifications which needed to be considered for impact on the accounting for the lease agreement are a change in the method of calculating leasing fee and a change in the initial lease term from 1 year to 2 years. Under the New CDMA Lease Agreement, the Group believes the uncertainties of the CDMA business continue to exist, particularly due to the fact that (i) the CDMA business still recorded a loss in 2005; (ii) the uncertainty of the future success of CDMA business arising from keen market competition; and (iii) the uncertainty in the future changes in technology, technological standards and government regulatory environment. At the inception of the New CDMA Lease Agreement, the Company was unable to determine whether it would renew the lease after the initial two-year lease term or whether it would exercise the purchase option. Given these uncertainties, the Group considered the risks associated with the ownership of the CDMA assets still substantially remained with Unicom Group and Unicom New Horizon, and has concluded the leasing of the CDMA network was classified as an operating lease.

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At the end of the lease term, the Group will reassess the appropriate classification based on the relevant factors and circumstances available at that time. Based on the above accounting judgement made, the operating lease expense has been recorded in the statements of income since the commencement of the Original CDMA Lease Agreements and the New CDMA Lease Agreement, and the carrying value of the CDMA assets and the related liabilities have not been reflected in the balance sheets. For the year ended December 31, 2005, the lease expense of approximately RMB7.92 billion (2003: RMB3.52 billion; 2004: RMB6.59 billion) was recorded under the leased lines and network capacities in the statements of income.

## 5. SEGMENT INFORMATION

The Group is organized into 5 business segments based on the various types of telecommunications services provided to customers in the PRC. The major business segments operated by the Group are classified as below:

- **GSM Business** the provision of GSM telephone and related services;
- **CDMA Business** the provision of CDMA telephone and related services, through a leasing arrangement of CDMA network capacities from Unicom New Horizon (Note 4.2(b));
- **Data and Internet Business** the provision of domestic and international data, Internet and other related services; and
- **Long Distance Business** the provision of domestic and international long distance and other related services.
- **Paging Business** the provision of paging and related services (discontinued in 2004).

The Group's primary measure of segment results is based on segment income or loss before taxation. Unallocated costs primarily represent corporate expenses and income taxes whilst unallocated income represents interest income that was not identifiable to different operating segments.

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## 5.1 Business Segments

|  | 2005            |                  |                                     |                              |                        | 2004 (Restated) |            |                 |                  |                                     |                              |                       |             |
|--|-----------------|------------------|-------------------------------------|------------------------------|------------------------|-----------------|------------|-----------------|------------------|-------------------------------------|------------------------------|-----------------------|-------------|
|  | GSM<br>Business | CDMA<br>Business | Internet<br>and<br>Data<br>Business | Long<br>Distance<br>Business | Unallocated<br>amounts | Elimination     | Total      | GSM<br>Business | CDMA<br>Business | Internet<br>and<br>Data<br>Business | Long<br>Distance<br>Business | Unallocated<br>amount | Elimination |
| Revenue (Turnover):                        |                 |                  |                                     |                              |                        |                 |            |                 |                  |                                     |                              |                       |             |
| Usage fee                                  | 32,077,305      | 16,726,678       | 2,540,574                           | 599,251                      |                        |                 | 51,943,808 | 31,997,020      | 16,164,333       | 2,685,083                           | 879,281                      |                       |             |
| Monthly fee                                | 6,840,720       | 4,905,538        |                                     |                              |                        |                 | 11,746,258 | 6,922,400       | 4,638,024        |                                     |                              |                       |             |
| Interconnection<br>revenue                 | 3,466,067       | 1,398,577        | 102,989                             | 434,577                      |                        |                 | 5,402,210  | 2,614,268       | 927,288          | 131,371                             | 454,383                      |                       |             |
| Rental income                              |                 |                  | 393,659                             | 489,969                      |                        |                 | 883,628    |                 |                  | 344,014                             | 512,134                      |                       |             |
| Other revenue                              | 9,751,436       | 4,546,143        | 12,745                              | 776                          |                        |                 | 14,311,100 | 5,975,264       | 2,648,029        | 502,266                             | 2,211                        |                       |             |
| Total services<br>revenue                  | 52,135,528      | 27,576,936       | 3,049,967                           | 1,524,573                    |                        |                 | 84,287,004 | 47,508,952      | 24,377,674       | 3,662,734                           | 1,848,009                    |                       |             |
| Sales of<br>telecommunications<br>products | 3,174           | 2,743,337        | 7,226                               | 8,090                        |                        |                 |            |                 |                  |                                     |                              |                       |             |