

# Report of the Directors

The Board of Directors of China Communications Services Corporation Limited (the “Company”) is pleased to present the Report of the Directors of the Company, together with the audited financial statements of the Company and its subsidiaries (the “Group”) prepared in accordance with International Financial Reporting Standards for the year ended 31 December 2006.

## PRINCIPAL BUSINESSES

The Group is a leading integrated service provider in the PRC which provides specialized telecommunications support services to telecommunications operators. We offer telecommunications infrastructure services, including design, construction and project supervision and management; business process outsourcing services, including network maintenance, facilities management, and distribution of telecommunications services and products; applications, content and other services, including IT applications, Internet services, and value-added voice services, as well as other services. We also provide services to telecommunications equipment manufacturers and large enterprises in the PRC. The principal business of the Company is investment holding.

## RESULTS

Results of the Group for the year ended 31 December 2006 and the financial position of the Company and the Group as at that date are set out in the audited financial statements on page 62 to page 122 in this Annual Report.

## DIVIDENDS

As disclosed in the Prospectus of the Company dated 27 November 2006, in accordance with the “Provisional Regulations on the Administration of State-owned Capital and Financial Treatment in the Corporate Restructuring of Enterprises” which was issued by the PRC Ministry of Finance and a resolution passed on 1 November 2006, the directors proposed, and the shareholders approved, the distribution of profit of the Group for the period from 1 April 2006 to 29 August 2006, being the calendar day immediately preceding the date of incorporation of the Company. In the same resolution, the directors proposed, and the shareholders approved, the distribution of profit of the Group for the period from 30 August 2006, being the date of incorporation of the Company, to the calendar day immediately preceding the date of its listing on the Stock Exchange (i.e. 7 December 2006) (together, the “2006 Special Dividend”).

Pursuant to a resolution passed at a directors’ meeting on 17 April 2007, the directors resolved to pay the 2006 Special Dividend to China Telecommunications Corporation (“China Telecom”) and its subsidiaries amounting to RMB535 million in total (being the distributable profit of the Group for the period from 1 April 2006 to 7 December 2006). The Company will pay the 2006 Special Dividend to China Telecom and its subsidiaries in a series of payments commencing in July 2007.

The directors do not recommend the payment of a final dividend for 2006.

## USE OF PROCEEDS FROM THE INITIAL PUBLIC OFFERING

The gross proceeds (before deduction of expenses) from the initial public offering of H shares of the Company was about HK\$3,267 million. Up to 31 December 2006, the proceeds were placed in short-term deposit bank accounts. According to the plan of use of proceeds disclosed in the prospectus of the Company dated 27 November 2006, the Company will use approximately 50% of the net proceeds for capital expenditure items over the next 24 months, approximately 40% for the implementation of our business strategies and funding of business expansion, including potential acquisitions of specialized telecommunications support business from China Telecom and other strategic investments and approximately 10% for additional working capital and for other general corporate purposes.

## DIRECTORS AND SENIOR MANAGEMENT OF THE COMPANY

The following table sets out information concerning the directors and senior management of the Company as at the date of this report:

Name	Position in the Company	Date of appointment
Wang Xiaochu	Chairman and Non-executive Director	3 August 2006
Li Ping	Vice Chairman, Executive Director, Chief Executive Officer	3 August 2006
Liu Aili	Non-executive Director	12 October 2006
Zhang Junan	Non-executive Director	12 October 2006
Wang Jun	Independent Non-executive Director	26 September 2006
Chan Mo Po, Paul	Independent Non-executive Director	26 September 2006
Zhao Chunjun	Independent Non-executive Director	26 September 2006
Wu Shangzhi	Independent Non-executive Director	26 September 2006
Hao Weimin	Independent Non-executive Director	27 October 2006
Zhang Zhiyong	Executive Vice President and Chief Operating Officer	16 October 2006
Li Zhigang	Executive Vice President	16 October 2006
Yuan Jianxing	Executive Vice President and Chief Financial Officer	16 October 2006
Wang Qi	Executive Vice President	16 October 2006
Li Jian	Executive Vice President	16 October 2006
Liu Xiaoyi	Executive Vice President	16 October 2006
Chung Wai Cheung, Terence	Company Secretary, Assistant Chief Financial Officer and Qualified Accountant	16 October 2006

# Report of the Directors

The following table sets out information concerning the senior management of the provincial subsidiaries of the Company as at the date of this report:

Name	Position in the Group	Date of appointment
Wang Qi	Executive Vice President of the Company and Chief Executive Officer of Guangdong Communications Services Corporation Limited	17 August 2006
Yuan Jinling	Chief Executive Officer of Shanghai Communications Services Corporation Limited	17 August 2006
Shi Yongsheng	Chief Executive Officer of Zhejiang Communications Services Corporation Limited	17 August 2006
Yang Yonghe	Chief Executive Officer of Fujian Communications Services Corporation Limited	13 March 2007
Gao Liangping	Chief Executive Officer of Hubei Communications Services Corporation Limited	17 August 2006
Bao Tiejun	Chief Executive Officer of Hainan Communications Services Corporation Limited	17 August 2006

In March 2007, Yang Yonghe was appointed as the chief executive officer of Fujian Communications Services Corporation Limited while Xu Qiude resigned from the position of chief executive officer of Fujian Communications Services Corporation Limited.

## SUPERVISORS OF THE COMPANY

The following table sets out information concerning the supervisors of the Company as at the date of this report:

Name	Position in the Company	Date of appointment
Xia Jianghua	Chairperson of the Supervisory Committee	3 August 2006
Hai Liancheng	Independent Supervisor	3 August 2006
Yan Dong	Supervisor (Employee Representative)	15 August 2006

Profile of the directors, supervisors and senior management is set out in the section of this Annual Report entitled "Directors, Supervisors and Senior Management" .

## SHARE CAPITAL

The Company was incorporated on 30 August 2006, and the registered capital was 3,960,000,000 ordinary domestic shares with a par value of RMB1.00 each. China Telecom holds 3,623,400,000 ordinary shares, accounting for 91.50% of our total issued shares; Guangdong Telecom Industry Group Corporation (a wholly owned subsidiary of China Telecom) holds 245,520,000 ordinary shares, accounting for 6.20% of the aggregate shares and Zhejiang Telecom Industry Corporation (a wholly owned subsidiary of China Telecom) holds 91,080,000 ordinary shares, accounting for 2.30% of the aggregate shares.

In December 2006, the Company issued 1,484,986,000 H shares with a par value of RMB1.00 each, at a price of HK\$2.20 per H share by way of an initial public offering to Hong Kong and overseas investors. In connection with the initial public offering, the promoters of the Company converted 148,498,600 domestic state-owned shares of RMB1.00 each into H shares on a one domestic share to one H-share basis and transferred them to the National Council for Social Security Fund of the PRC. A total of 1,633,484,600 H shares were listed on the Stock Exchange of Hong Kong Limited ("the Stock Exchange"). As at 31 December 2006, the share capital of the Company comprised:

Shares	Number of Shares	Approximate % of issued share capital
Domestic shares (Total)	3,811,501,400	70%
Domestic shares held by:		
China Telecommunications Corporation <sup>(1)</sup>	3,487,523,782	64.05%
Guangdong Telecom Industry Group Corporation	236,313,086	4.34%
Zhejiang Telecom Industry Corporation	87,664,532	1.61%
H shares (Total)	1,633,484,600	30%
Total	5,444,986,000	100%

<sup>(1)</sup> Pursuant to the equity transfer agreement entered into between China Telecommunications Corporation ("China Telecom"), China Mobile Communications Corporation ("China Mobile") and China United Telecommunications Corporation ("China Unicom"), China Telecom agreed to transfer 506,880,000 and 229,680,000 domestic shares to China Mobile and China Unicom respectively. China Telecom will hold the said portion of shares until the date on which the conditions precedent to the equity transfer are met. The equity transfer is conditional upon the equity transfer agreement having been executed, the lapse of at least one year from the listing date and the transfer having been approved by the State-Owned Assets Supervision and Administration Commission of the PRC and the name of the transferee being registered in the Company's share register. Details of the equity transfer agreement are disclosed in the Company's prospectus dated 27 November 2006.

# Report of the Directors

## MATERIAL INTERESTS AND SHORT POSITIONS IN SHARES AND UNDERLYING SHARES OF THE COMPANY

As at 31 December 2006, the interests or short positions of persons who are entitled to exercise or control the exercise of 5% or more of the voting power at any of the Company's general meetings (excluding the Directors and Supervisors) in the shares and underlying shares of equity derivatives of the Company as recorded in the register required to be maintained under Section 336 of the Securities and Futures Ordinance (Cap 571 of the Laws of Hong Kong) (the "SFO") are as follows:

Name of shareholder	Number of shares held	Type of shares	Percentage of the respective type of shares (%)	Percentage of the total number of shares in issue (%)	Capacity
China Telecommunications Corporation <sup>(1)</sup>	3,811,501,400	Domestic shares	100.00	70.00	Beneficial Owner
China Mobile Communications Corporation <sup>(2)</sup>	506,880,000	Domestic shares	13.30	9.31	Beneficial Owner
Guangdong Telecom Industry Group Corporation <sup>(1)</sup>	236,313,086	Domestic shares	6.20	4.34	Beneficial Owner
Cisco Systems International B.V.	176,676,000 (L)	H shares	10.82	3.24	Beneficial Owner
The National Council for Social Security Fund of the PRC	129,129,300 (L)	H shares	7.91	2.37	Beneficial Owner
JPMorgan Chase & Co.	107,515,500 (L)	H shares	6.58	1.97	Investment Manager,
	94,691,500 (P)	H shares	5.80	1.74	Custodian – Licensed Corporation/ Approved Leading Agent
INVESCO Hong Kong Limited (previously known as INVESCO Asia Limited)	85,682,000 (L)	H shares	5.25	1.57	Investment Manager

Remarks: (L): Long Position; (P): Lending Pool

- (1) Since China Telecom indirectly holds 100% of the shares in Guangdong Telecom Industry Group Corporation and Zhejiang Telecom Industry Corporation, the 323,977,618 domestic shares held in total by Guangdong Telecom Industry Group Corporation and Zhejiang Telecom Industry Corporation are considered and aggregated as the equity interest of China Telecom.
- (2) Please refer to the remarks in the section of this report entitled "Share Capital" for details of the equity transfer agreement entered into between China Telecom and China Mobile and the conditions to be met before the equity transfer becomes effective.

Save as stated above, as at 31 December 2006, in the register required to be maintained under Section 336 of the SFO, no other persons were recorded as holding any interests or short positions in the shares or underlying shares of the equity derivatives of the Company.

## **DIRECTORS' AND SUPERVISORS' INTERESTS AND SHORT POSITIONS IN SHARES, UNDERLYING SHARES AND DEBENTURES**

As at 31 December 2006, none of the directors and supervisors of the Company had any interests or short positions in the shares, underlying shares of equity derivatives or debentures of the Company or its associated corporations (within the meaning of Part XV of the SFO) as recorded in the register required to be maintained under Section 352 of the SFO or as otherwise notified to the Company and The Stock Exchange of Hong Kong Limited pursuant to the Model Code for Securities Transactions by Directors of Listed Companies. As at 31 December 2006, the Company had not granted its Directors or Supervisors, or their respective spouses or children below the age of 18 any rights to subscribe for the shares or debentures of the Company or any of its associated corporations and none of them has ever exercised any such right to subscribe for shares or debentures.

## **PUBLIC FLOAT**

Based on information that is publicly available to the Company and within the knowledge of the Directors, the Company has maintained the prescribed public float under the Listing Rules for the period from the date of listing to the date of this report.

## **DIRECTORS' AND SUPERVISORS' SERVICE CONTRACT**

Each of the directors and supervisors has entered into a service contract with the Company. According to the service contract, each of the contracts has an initial term of 3 years and is renewable in accordance with the Articles of Association of the Company when the initial term expires. These contracts are terminable at the option of either party by giving three months' notice in writing or according to the terms of the contract prior to the expiry of the contract.

## **DIRECTORS' AND SUPERVISORS' INTERESTS IN CONTRACTS**

For the year ended 31 December 2006, no Director or Supervisor of the Company had any material interest, whether direct or indirect, in any contract of significance entered into by the Company, any of its holding companies or subsidiaries or fellow subsidiaries, apart from service contracts.

## **EMOLUMENTS OF THE DIRECTORS AND SUPERVISORS**

Based on the overall remuneration policy of the Company and with reference to the payroll standard of same industry companies in the market, the remuneration of Directors and Supervisors is determined after taking into account the scope of duties and their complexities. Please refer to note 11 of the audited financial statements for details of the emoluments of the Directors and Supervisors of the Company in 2006.

## **PURCHASE, SALE AND REDEMPTION OF SHARES**

Neither the Company nor any of its subsidiaries has purchased, sold or redeemed any securities of the Company during the reporting period.

# Report of the Directors

## SUMMARY OF FINANCIAL INFORMATION

Please refer to pages 123 to 124 of this Annual Report for a summary of the operating results, assets and liabilities of the Group for each of the years in the four-year period ended 31 December 2006.

## BANK LOANS AND OTHER BORROWINGS

Please refer to note 30 of the audited financial statements for details of bank loans and other borrowings of the Group.

## PROPERTY, PLANT AND EQUIPMENT

Please refer to note 16 of the audited financial statements for movements in the fixed assets of the Group for the year ended 31 December 2006.

## DISTRIBUTABLE RESERVES

Please refer to note 41 of the audited financial statements for details of the movements in the reserves of the Company for 2006.

## DONATIONS

For the year ended 31 December 2006, the Group made charitable and other donations to a total amount of RMB1.80 million.

## SUBSIDIARIES AND ASSOCIATED COMPANIES

Please refer to note 21 and note 22 of the audited financial statements for details of the Company's subsidiaries and the Group's interests in associated companies as at 31 December 2006.

## CHANGES IN EQUITY

Please refer to the consolidated statement of changes in equity contained in the audited financial statements (page 66 of this Annual Report).

## PLAN OF EMPLOYEES' RETIREMENT BENEFITS

Please refer to note 34 of the audited financial statements for details of the retirement benefits provided by the Group.

## PRE-EMPTIVE RIGHTS

There are no provisions for pre-emptive rights in the Articles of Association requiring the Company to offer new shares to the existing shareholders in proportion to their shareholdings.

## MAJOR CUSTOMERS AND SUPPLIERS

For the reporting period, the sales to the five largest customers of the Group represented 69.4% of the operating revenue of the Group; of which, the sales to the largest customers of the Group represented 53.1% of the operating revenue of the Group. The purchases from the five largest suppliers of the Group accounted for less than 30% of the total annual purchases of the Group.

So far as the Directors are aware, as disclosed in the prospectus of the Company, of the five largest customers of the Group, China Telecom holds 70% equity interest of the Company, and has agreed to transfer 506,880,000 domestic shares of the Company and 229,680,000 domestic shares of the Company to China Mobile and China Unicom, respectively. China Telecom will keep holding the aforementioned shares prior to the completion of the transfer. As at 31 December 2006, Mr. Liu Aili, a non-executive director of the Company, held 141,500 share purchase options in China Mobile Limited, a subsidiary of China Mobile, one of our five largest customers of the Group, and Mr. Zhang Junan, a non-executive director of the Company, held 500,000 share purchase options in China Unicom Corporation Limited, a subsidiary of China Unicom, one of our five largest customers of the Group.

Other than that, no director of the Group, their associates, or any person holding more than 5% of the issued share capital of the Company has any interests in such suppliers or customers.

## CONTINUING CONNECTED TRANSACTIONS

Pursuant to Chapter 14A of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited, the transactions between the Group and China Telecom and its subsidiaries (excluding our Group and including China Telecom Corporation Limited, collectively the "China Telecom Group") will constitute connected transactions of the Group.

The following table sets out the amounts of continuing connected transactions of the Group during the year ended 31 December 2006:

Transaction	The Group (RMB million)	Annual cap of continuing connected transaction (RMB million)
Engineering services provided to China Telecom Group	4,126.27	4,700.00
Ancillary telecommunications services provided to China Telecom Group	2,197.98	2,300.00
Operation support services provided to/by China Telecom Group	Revenue 1,017.24 Expenditure 104.25	1,300.00 170.00
IT application services provided to/by China Telecom Group	Revenue 147.06 Expenditure 170.93	250.00 190.00
Property leasing provided to/by China Telecom Group	Revenue 45.38 Expenditure 45.33	68.50 76.50
Centralized services provided to China Telecom Group	45.10	250.00



# Report of the Directors

## Continuing Connected Transactions Agreements Between the Group and China Telecommunications Corporation

The Group and China Telecom entered into six continuing connected transactions agreements on 16 November 2006 to manage the connected transaction between the Group and China Telecom Group. These agreements are the Engineering Framework Agreement, the Ancillary Telecommunications Services Framework Agreement, the Operation Support Services Framework Agreement, the IT Application Services Framework Agreement, the Property Leasing Framework Agreement and the Centralized Services Agreement. The terms of the above six agreements will expire on 31 December 2008 and are automatically renewable for further periods of no more than three years subject to shareholders' approval unless terminated early by either party with three months' written notice.

### Engineering Framework Agreement

Pursuant to the Engineering Framework Agreement, the Company agreed to provide certain engineering related services, such as design, construction, project supervision and management for telecommunications infrastructure projects undertaken by China Telecom Group. The charges payable for engineering-related services rendered under the Engineering Framework Agreement shall be determined by reference to market rates or as reflected by prices obtained through the tender process. The Company would be accorded priority by China Telecom Group in the provision of the engineering related services except in tenders, provided that the terms and conditions offered by independent third parties to China Telecom Group are no more favourable than those offered by the Company for the same services, and in return, the Company has undertaken to China Telecom Group that the Company shall not provide services to it on terms which are less favourable than those offered by the Company to independent third parties.

### Ancillary Telecommunications Services Framework Agreement

Pursuant to the Ancillary Telecommunications Services Framework Agreement, the Company agreed to provide to China Telecom Group certain ancillary telecommunications services such as maintenance of network facilities including equipment, ducts and cables, equipment rooms and base stations; distribution of telecommunications products and services; provision of application, content and other services such as fixed-line value-added services, wireless value-added services, Internet value-added services, and the development of online gaming, certificate authentication and the value-added business platform of Internet cafes (the "Ancillary Telecommunications Services"). The Ancillary Telecommunications Services Framework Agreement stipulates that the Ancillary Telecommunications Services be provided at:

- (1) government-prescribed price;
- (2) where there is no government-prescribed price but where there is a government-guidance price, the government-guidance price applies
- (3) where there is neither a government-prescribed price nor a government-guidance price, the market price applies. The market price is defined as the price at which the same type of services are provided by independent third parties in the ordinary course of business; or
- (4) where none of the above is applicable, the price is to be agreed between the relevant parties for the provision of the above services, which shall be the reasonable cost incurred in providing the same plus a reasonable profit (For this purpose, "reasonable costs" means the costs confirmed by both parties after negotiations, and "reasonable profits" means a profit ratio confirmed by both parties during the course of normal commercial negotiation, taking into account factors such as historical price, transaction size, average profit ratio within the relevant industry, supply and demand, labour cost, local commodity prices and economic development levels).

The Company will be given priority by China Telecom Group in the provision of the Ancillary Telecommunications Services, provided that the terms and conditions offered by independent third parties to China Telecom Group are no more favourable than those offered by us for the same services, and in return, we have undertaken to China Telecom Group that we shall not provide Ancillary Telecommunications Services to it on terms which are less favourable than those offered by us to independent third parties.

### **Operation Support Services Framework Agreement**

Pursuant to the Operation Support Services Framework Agreement, the Company agreed to provide to China Telecom Group, operation support services, including but not limited to facilities management and renovation, network facilities management in relation to buildings used for telecommunications purposes, labour resources management, equipment maintenance, advertisements, conferencing services, vehicles, and certain repair and leasing of equipment. Under the same Operation Support Services Framework Agreement, China Telecom Group has agreed to provide operation support services such as logistic services, warehouse, medical care, food and beverages, educational, hotel and travelling services, labour services and other services to us. Each of the parties will accord priority to the other party in the provision of the operation support services, provided that the terms and conditions offered by independent third parties to the relevant party are no more favourable than those offered by the other party for the same services, and in return, each of the parties has undertaken to the other that it shall not provide services to the other on terms which are less favourable than those offered to independent third parties. The operation support services under the Operation Support Services Framework Agreement are provided in accordance with the same pricing policy as that of the Ancillary Telecommunications Services Framework Agreement.

### **IT Application Services Framework Agreement**

Pursuant to the IT Application Services Framework Agreement, the Company agreed to provide China Telecom Group with telecommunications network support services, software and hardware development and other related IT services. China Telecom Group has also agreed to provide to the Company certain IT application services including but not limited to, basic telecommunications services such as voice and data, value-added services and information application services. The charges payable for such IT application services under the IT Application Services Framework Agreement shall be determined by reference to market rates, for example, rates as reflected by prices obtained through the tender process (with a minimum of three parties tendering bids). The party receiving the relevant services will accord priority to the party providing such services, provided that the terms and conditions offered by independent third parties to the relevant party are no more favourable than those offered by the other party for the same services, and in return, each of the parties has undertaken to the other that it shall not provide services to the other on terms which are less favourable than those offered to independent third parties.

### **Centralized Services Agreement**

Pursuant to the Centralized Services Agreement, the centralized services to be provided by the Company to China Telecom Group include:

1. the corporate headquarters management function to manage assets of China Telecom Group's retained specialised telecommunications support businesses in provinces, municipalities and autonomous regions including Jiangsu, Anhui, Jiangxi, Sichuan, Chongqing, Hunan, Guizhou, Yunnan, Guangxi, Shaanxi, Ningxia, Gansu, Qinghai, Xinjiang, Tibet and any remaining assets, such as hotels, manufacturing plants not in association with the specialized telecommunications support businesses, schools and hospitals, resulting from the restructuring of the Company in the Company's Primary Service Regions (including Shanghai municipality, and Zhejiang, Fujian, Hubei, Guangdong and Hainan Provinces in the PRC); and
2. the provincial headquarters management function to manage remaining assets resulting from the restructuring of the Company in the Company's Primary Service Regions.

# Report of the Directors

Except otherwise agreed by the parties, the aggregate administrative expenses incurred by us for the provision of the centralized services referred to above (all expenses incurred in connection with the above-mentioned headquarters management functions except remuneration for Directors, share appreciation rights and provision of bad debts) will be apportioned pro rata between the Company and China Telecom Group according to the proportional net asset value of each of the relevant parties.

## Property Leasing Framework Agreement

Pursuant to the Property Leasing Framework Agreement, the rental charges of each property of the Company and China Telecom Group leased by each party from another party are based on market rates. Rental charges are payable monthly in arrears, except as otherwise agreed by parties, and are subject to review every three years by both parties confirming after negotiations whether to adjust the rental charges and the amount of such adjustment.

## CONNECTED TRANSACTION AGREEMENT BETWEEN THE GROUP AND CHINA TELECOM CORPORATION LIMITED (OUR FELLOW SUBSIDIARY)

### Strategic Cooperation Agreement

We have entered into a Strategic Cooperation Agreement dated 30 August 2006 with China Telecom Corporation Limited, on behalf of its six wholly-owned subsidiaries, namely Shanghai Telecom Company Limited, Zhejiang Telecom Company Limited, Fujian Telecom Company Limited, Hubei Telecom Company Limited, Guangdong Telecom Company Limited, Hainan Telecom Company Limited and their respective subsidiaries for a period of three years commencing 1 January 2007 until 31 December 2009, renewable by mutual agreement and extendable in geographical areas. The areas for strategic business cooperation between the parties shall include engineering related services in connection with our design, construction, project supervision and management businesses; maintenance and management services including but not limited to our network maintenance and facilities management; and certain business process operation services such as integrated information solutions and call centres; and provision of applications, content and other services such as system integration and value-added services.

It is stipulated that the relevant services provided under the Strategic Cooperation Agreement shall be provided at an applicable standard price determined in the following order:

1. government-prescribed price;
2. where there is no government-prescribed price but there is a government-guided price, the government-guidance price applies;
3. where there is neither a government-prescribed price nor a government-guidance price, the market price applies. The market price is defined as the price at which the same type of services are provided by independent third parties in the ordinary course of business; or
4. where none of the above are applicable, the price is to be agreed between the relevant parties for the provision of the above services based on arm's length negotiation and shall be equal to the reasonable cost incurred in providing the same plus a reasonable profit.

The Group would be accorded priority by China Telecom Corporation Limited in the provision of the relevant services, provided that the terms and conditions offered by independent third parties to China Telecom Corporation Limited are no more favourable than those offered by us for the same services, and in return, under the same terms and conditions, we have undertaken to China Telecom Corporation Limited that we shall not provide services to it on terms which are less favourable than those offered by us to independent third parties.

In relation to the Group's provision of engineering related services in design, construction, project supervision and management businesses, China Telecom Corporation Limited has undertaken that the relevant subsidiaries of China Telecom Corporation Limited in the six provinces (including municipalities), being Shanghai, Zhejiang, Fujian, Hubei, Guangdong and Hainan, shall spend an annual minimum amount of not less than 12.5% of the total annual capital expenditure of the six corresponding wholly-owned provincial subsidiaries of China Telecom Corporation Limited, provided our terms and conditions for the provision of the engineering related services are no less favourable than those offered by any independent third parties and in return, we shall offer at least 5% discount for the engineering-related services to be provided to the relevant wholly-owned provincial subsidiaries of China Telecom Corporation Limited based on the applicable standard prices. Such discount is on normal commercial terms and it is in-line with market practice to give a discount as favourable treatment offered to large enterprise customers which are able to commit to a minimum purchase volume per annum. The percentage discount depends on a number of factors, such as the committed minimum purchase volume, competition and so on. The Company will undertake, among other things, to implement quality control during the provision of the one-stop engineering related services.

In relation to the Company's provision of maintenance and management services including but not limited to our network maintenance and facilities management businesses, China Telecom Corporation Limited has undertaken that the relevant subsidiaries of China Telecom Corporation Limited in the six provinces (including municipalities), being Shanghai, Zhejiang, Fujian, Hubei, Guangdong and Hainan, shall spend an annual minimum amount of not less than RMB1,330 million provided the Company's terms and conditions for the provision of the maintenance and management services are no less favourable than those offered by any independent third parties and in return, the Company has undertaken to fully utilize our competitive edge on having established professional operations with economies of scale to assist China Telecom Corporation Limited to achieve the goals of lowering its costs and expenditure.

In relation to the Company's provision of business process outsourcing services, integrated information solutions, call centre and other services such as system integration and value-added services, China Telecom Corporation Limited has undertaken to use its best endeavours to grant us business opportunities, provided our terms and conditions for the provision of such services are no less favourable than those offered by any independent third parties. In return, the Company will utilize our capacities and resources to support the strategic transformation of China Telecom Corporation Limited into an integrated information service provider.

The annual caps for the provision of the relevant services contemplated under the Strategic Cooperation Agreement have already been set out in the Engineering Framework Agreement, the Ancillary Telecommunications Services Framework Agreement, the Operation Support Services Framework Agreement and the IT Application Services Framework Agreement referred to below and therefore no separate annual caps shall be applied to the Strategic Cooperation Agreement.

The independent non-executive directors have confirmed that all continuing connected transactions for the year ended 31 December 2006 to which the Group was a party:

1. had been entered into, and that the agreements governing those transactions had been entered into, by the Group in the ordinary and usual course of business;
2. had been entered into either:
  - (i) on normal commercial terms; or
  - (ii) where there was no available comparison to judge whether they are on normal commercial terms, are on terms no less favourable than those available to or (if applicable) from independent third parties; and

# Report of the Directors

- had been entered into on terms that are fair and reasonable so far as the overall interests of the independent shareholders of the Company are concerned.

The independent non-executive directors have further confirmed that:

The values of continuing connected transactions entered into between the Group and its connected persons which are subject to annual caps have not exceeded their respective annual caps.

The auditors of the Company have performed procedures on the transactions and issued a letter to the Board to advise that:

- the transactions entered into between the Group and China Telecom during the year ended 31 December 2006 have been approved by the Directors;
- they have not found that the transactions entered into between the Group and China Telecom during the year ended 31 December 2006 were not in accordance with the pricing policies as stated in the relevant agreements;
- they have not found that the transactions entered into between the Group and China Telecom during the year ended 31 December 2006 were not in accordance with the terms of the agreements governing the transactions;
- they note that the transactions have not exceeded the 2006 annual caps as disclosed in the prospectus.

## EMPLOYEES

As at 31 December 2006, the Group has 71,666 employees illustrated as follows:

	Number of staff	Percentage
Management	5,016	7%
Technical and marketing	20,066	28%
Operations	46,584	65%
Total	71,666	100%

The Company has implemented a performance-linked remuneration system. Remuneration for employees includes basic salary, performance-based bonus and welfare. In addition, the Company also emphasizes the importance of employee training and uses various means of training to improve the quality and capability of key employees.

## COMPLIANCE WITH CODE ON CORPORATE GOVERNANCE PRACTICES

Please see the “Corporate Governance Report” set out in this Annual Report of the Company for details of our compliance with the Code on Corporate Governance Practices.

## MATERIAL LEGAL PROCEEDINGS

As at 31 December 2006, so far as the Directors are aware, the Company was not involved in any material litigation or arbitration and no material litigation claims had been made against, or were pending or threatened against the Company.

## NON-ADJUSTING POST BALANCE SHEET EVENT

The Corporate Income Tax Law of the People’s Republic of China (the “New Tax Law”) has been passed by the Fifth Plenary Session of the Tenth National People’s Congress on 16 March 2007 and will take effect on 1 January 2008. According to the New Tax Law, except for certain subsidiaries of the Company which are taxed at a preferential rate, the income tax rate applicable to the Group will be reduced from 33% to 25% from 1 January 2008. From 1 January 2008, certain subsidiaries which are currently taxed at preferential rates will be subject to a five-year transition period during which the tax rates will gradually be increased to the unified rate of 25% and certain high-tech enterprises will continue to be entitled to a reduced tax rate of 15%. However, the New Tax Law has not set out the details of how the existing preferential tax rate will gradually increase to the standard rate of 25% and the detailed implementation rules regarding the preferential tax policies (e.g. the details of how a taxpayer can be qualified as a high-tech enterprise to enjoy the preferential rate of 15%) have yet to be made public. Consequently, management is not in a position to estimate the impact of the New Tax Law on the deferred tax assets and liabilities of certain subsidiaries which are being taxed at preferential rates. The financial effect of the New Tax Law, if any, will be reflected in the Group’s 2007 financial statements. The enactment of the New Tax Law is not expected to have any financial effect on the amounts accrued in the balance sheet in respect of current tax payable.

## AUDITORS

KPMG and KPMG Huazhen were engaged as the international and domestic auditors of the Company for the year ended 31 December 2006. KPMG has audited the accompanying financial statements, which have been prepared in accordance with International Financial Reporting Standards. The Company has retained KPMG and KPMG Huazhen since the date of its listing. A resolution for the reappointment of KPMG and KPMG Huazhen as the international and domestic auditors of the Company for the year ending 31 December 2007 will be proposed at the annual general meeting of the Company.

By order of the Board

**Wang Xiaochu**

*Chairman*

Beijing, China  
17 April 2007