

Report of the Directors

The Group continues
to strive for maximising value
for Shareholders



The Board of Directors of the Company hereby presents this report and the audited consolidated financial statements of the Group for the year ended 31 December, 2002.

Principal Activities, Operating Results and Financial Position

The Group is principally engaged in airline operations. The Group also operates certain airline related businesses including aircraft maintenance and air catering operations. The Group is one of the largest airlines in China. In 2002, the Group ranked first among all Chinese airlines in terms of passenger traffic volume, number of scheduled flights per week, number of hours flown, number of routes and size of aircraft fleet. The Group has prepared the results of operations for the year ended 31 December, 2002, and the financial position of the Company and the Group as of that date in accordance with International Financial Reporting Standards ("IFRS"). See pages 42 to 108 of this Annual Report.

Five Year Summary

A summary of the results and the assets and liabilities of the Group for the five-year period ended 31 December, 2002 are set out on pages 109 and 110 of this Annual Report.

Acquisition of Assets from CSAHC

On 29 August, 2002, the Company entered into agreements with CSAHC to acquire 90% registered capital in each of Guangzhou Aviation Hotel, South China International Aviation & Travel Services Company and Southern Airlines Advertising Company of CSAHC at considerations of RMB99,048,000,

RMB4,999,000 and RMB3,799,000 respectively. The remaining 10% registered capital in each of these companies is still held by CSAHC. Following the transfer, Guangzhou Aviation Hotel, South China International Aviation and Travel Services Corporation and Southern Airlines Advertising Company became subsidiaries of the Company.

The Board of the Directors believes that the aforesaid transactions may enable the Company to achieve vertical integration and cost control and help the Company to expand its service base and enhance its brand name.

A Shares Issue Plan

The Company has applied to the relevant PRC authorities for the issue of not more than 1,000,000,000 A Shares and the listing of such A Shares on the Shanghai Stock Exchange (the "A Shares Issue Plan"). The A Shares Issue Plan was approved by the Independent shareholders at the Extraordinary General Meetings held on 26 March, 2002 and 21 May, 2002, and the Board was authorised to plan for and on behalf of the Company deal with all relevant matters relating to the A Shares Issue.

Consolidation and Restructuring

On 11 October, 2001, the State Council of PRC approved the consolidation and restructuring among CSAHC, Northern Airlines and Xinjiang Airlines. The name of such new entity is China Southern Air Group.

Dividends

No interim dividend was paid during the year ended 31 December, 2002 (2001: Nil).

The Board of Directors of the Company does not recommend the payment of a final dividend in respect of the year ended 31 December, 2002.

A final dividend of RMB0.02 per share totalling RMB67,484,000 in respect of the previous financial year was approved and paid during the year.

Bank Loans and Other Borrowings

Details of the bank loans and other borrowings of the Company and the Group are set out in notes 21 and 22 to the financial statements.

Interest Capitalisation

For the year ended 31 December, 2002, RMB64,186,000 interest (2001: RMB5,227,000) was capitalised as the cost of construction in progress and fixed assets.

Fixed Assets

Fixed assets of the Company and the Group and movements of fixed assets during the year ended 31 December, 2002 are set out in note 10 to the financial statements.

Major Customers and Suppliers

The Group's five largest customers in the aggregate did not exceed 30% of the Group's total operating revenue (i.e. turnover) for the year ended 31 December, 2002.

The largest supplier and the aggregate of the five largest suppliers represented approximately 53% and 64%, respectively, of the Group's total purchases (not including purchases of items which are of a capital nature) for the year ended 31 December, 2002.

At no time during the year ended 31 December, 2002 have any Directors, associates of Directors or shareholders of the Company owning, to the knowledge of the Directors, more than 5% of the Company's share capital had any interest in the Group's five largest customers or suppliers.

Taxation

Details of taxation of the Company and the Group are set out in note 7 to the financial statements.

Reserves

Movements in the reserves of the Company and the Group during the year are set out in note 26 to the financial statements.

Employees and Employees' Pension Scheme

As at 31 December, 2002, the Group had an aggregate of 17,031 employees (2001: 16,368). Details of the employees' pension schemes and other welfare are set out in note 28 to the financial statements.

Subsidiaries

Details of the principal subsidiaries of the Company are set out in note 35 to the financial statements.

Share Capital Structure

As at 31 December, 2002, the total share capital of the Company was 3,374,178,000 shares, of which approximately 65.2% (2,200,000,000 state-owned shares) is held by CSAHC and approximately 34.8% (1,174,178,000 H shares) is held by Hong Kong and overseas shareholders.

Substantial Shareholders

As at 31 December, 2002, the following shareholders had an interest of 10% or more in the Company's shares:

Name	Number of Shares	Approximate
		Percentage of the Total Number of Shares
CSAHC	2,200,000,000	65.20%
HKSCC Nominees Limited	1,148,129,999	34.03%

The following persons have informed the Company that the Company's H shares held by them as at 31 December, 2002 in CCASS's stock accounts of HKSCC Nominees Limited were more than 10% of the total number of H shares issued by the Company:

Name	Number of H Shares	Approximate
		Percentage of the Total Number of Shares
The Hongkong and Shanghai Banking Corporation Limited	643,649,717	54.82%
Standard Chartered Bank	154,060,050	13.12%

Save for the information above, as at 31 December, 2002, the Company is not aware of any interests which are required to be reported pursuant to Section 16(1) of the Securities (Disclosure of Interests) Ordinance (Chapter 369 of the Laws of Hong Kong) (the "SDI Ordinance").

Purchase, Sale or Redemption of Shares

Neither the Company nor any of its subsidiaries purchased, sold or redeemed any shares of the Company during 2002.

Use of Proceeds from H Share Offering

As stated in the 2001 Annual Report of the Company, as of 31 December, 2001, the Company had RMB40 million remaining from the proceeds of the Company's initial public offering. As at 31 December, 2002, the sum of RMB40 million remained unused.

Consistent with the disclosure in the Prospectus of the Company dated July 1997, the Company intends to use the remaining proceeds of RMB40 million (held as at 31 December, 2002 as short-term deposits with Southern Airlines Group Finance Company Limited, a PRC authorised financial institution and an associated company of the Group) for various projects including the development of the computerised accounting system.

Pre-emptive Rights

Neither the Articles of Association of the Company nor the laws of the PRC provide for any pre-emptive rights requiring the Company to offer new shares to existing shareholders in proportion to their existing shareholdings.

Compliance with the Code of Best Practice

The Directors of the Company confirm that in the year ended 31 December, 2002, the Group was in compliance with the Code of Best Practice set out in Appendix 14 to the Main Board Listing Rules ("the Listing Rules") issued by the Stock Exchange of Hong Kong Limited ("Hong Kong Stock Exchange").



Directors, Supervisors and Senior Administrative Officers

Directors, Supervisors and Senior Administrative Officers of the Company in 2002 were as follows:

Name	Age	Position
Yan Zhi Qing	60	Chairman of the Board of Directors
Wang Chang Shun	45	Vice Chairman of the Board of Directors; President
Li Feng Hua	53	Director; Vice President
Wang Shao Xi	61	Director
Zhang Rui Ai	61	Director
Zhou Yong Jin	59	Director
Xu Jie Bo	37	Director; Chief Financial Officer
Wu Rong Nan	61	Director
Simon To	51	Independent Non-Executive Director
Peter Lok	66	Independent Non-Executive Director
Wei Ming Hai	38	Independent Non-Executive Director
Liang Hua Fu	61	Chairman of the Supervisory Committee
Gan Yu Hua	74	Supervisor
Li Qi Hong	55	Supervisor
Jiang Ping	52	Vice President
Li Kun	42	Vice President
Yuan Xin An	46	Vice President
Zheng En Ren	57	Vice President
Yang Guang Hua	49	Vice President
Su Liang	40	Company Secretary

On 12 April, 2002, the Board of Directors by resolutions appointed Mr. Yuan Xin An, Mr. Zheng En Ren and Mr. Yang Guang Hua respectively as Vice President of the Company.

On 11 October, 2002, Li Feng Hua resigned as the Director and Vice President of the Company due to work arrangement.

On 14 March, 2003, Mr. Wang Shao Xi and Mr. Zhang Rui Ai tendered their resignations to the Company as Directors of the Company due to retirement. Such resignations will take effect after approval at the 2002 Annual General Meeting of the Company.

Subject to passing of the proposed resolutions in the Company Annual General Meeting for the year 2003, the Company will appoint Liu Ming Qi, Peng An Fa, Wang Quan Hua, Zhao Liu An, Zhou Yong Qian, Wang Zhi and Sui Guan Jun as directors.

Biographical details of the Board of Directors, Senior Administrative Officers and members of the Supervisory Committee are set out on pages 111 to 115 of this Annual Report.

Equity Interests in the Company Held by the Directors and Supervisors

As at 31 December, 2002, none of the Directors or Supervisors of the Company held any interest in the Company or any associated corporation of the Company, which is required to be notified to the Company and the Hong Kong Stock Exchange pursuant to Section 28 of the SDI Ordinance, or which is required, pursuant to Section 29 of the SDI Ordinance, to be entered in the register of the Company.

At no time during 2002 or before has any Director, Supervisor or member of the Senior Administrative Officers or any of their spouses or minor children, been granted or exercised or subscribed for shares or debentures or options of the Company.

Service Contracts of the Directors and Supervisors

All Directors and Supervisors of the Company have entered into service contracts with the Company for a term of three years commencing on 16 April, 2001. Except for such service contracts, none of the Directors or Supervisors of the Company has entered or has proposed to enter into any other service contracts with the Company or its subsidiaries. None of the Directors or Supervisors has entered into any service contracts with the Company which is not determinable by the Company within one year without payment of compensation, other than statutory compensation.

Interests of the Directors and Supervisors in Contracts

In 2002, none of the Directors and Supervisors of the Company had a material interest in any contract of significance to which the Company or any of its subsidiaries was a party.

Connected Transactions

The Company enters from time to time into certain connected transactions with CSAHC and other connected persons. Such transactions fall within the definition of connected transactions as set out in Chapter 14 of the Listing Rules issued by the Stock Exchange of Hong Kong Limited ("the Hong Kong Stock Exchange"). The Hong Kong Stock Exchange has granted waivers to the Company in respect of compliance with certain provisions of Chapter 14 of the Listing Rules. Details of such transactions conducted during the year and/or the related agreements entered into between the Company and such parties for which waivers have been obtained are disclosed as follows:

(A) Demerger Agreement

The Demerger Agreement dated 25 March, 1995 (such Agreement was amended by Amendment No.1 dated 22 May, 1997) was entered into between the CSAHC and the Company for the purpose of defining and allocating the assets and liabilities between CSAHC and the Company. Under the Demerger Agreement, CSAHC and the Company have agreed to indemnify the other party against, among other things, claims, liabilities and expenses incurred by such other party but relating to the businesses, assets and liabilities held or assumed by CSAHC or the Company (as the case may be) pursuant to the Demerger Agreement.

Neither the Company nor CSAHC has been required to make any payments in respect of such indemnification obligations from the date of the Demerger Agreement up to the date of this report.

(B) Connected Business Transactions

The Company and CSAHC and their respective subsidiaries were a single group prior to the restructuring of CSAHC in 1995 in anticipation of the Company's global offering (the "Restructuring"). As a result, certain arrangements between them have continued after the Restructuring and the listing of the Company's shares on the Hong Kong Stock Exchange and New York Stock Exchange. At present, the Company and CSAHC (or their respective subsidiaries) have entered into the following agreements:

- (a) *Southern Airlines (Group) Import and Export Trading Company ("SAIETC"), a wholly-owned subsidiary of CSAHC*

The Company and SAIETC have entered into an agreement dated 22 May, 1997, for the import and export of aircraft, flight equipment, special vehicles for airline use, communication and navigation facilities, and training facilities for a term extending from 22 May, 1997 to 22 May, 2000 (renewable by the parties). The agreement has been extended to 22 May, 2003.

For the year ended 31 December, 2002, the amount incurred by the Group for the import and export of the above equipment was RMB583,548,000, inclusive of agency commission of 1.5% above the contract prices paid to SAIETC.

- (b) *Southern Airlines Advertising Company, which is 90% owned by the Company and 10% owned by CSAHC*

On 26 August, 2002, the Company had entered into a takeover agreement with CSAHC. As a result, the Company owns 90%, and CSAHC owns 10% of Southern Airlines Advertising Company.

The Company and Southern Airlines Advertising Company have entered into an agreement dated 22 May, 1997, for the provision of advertising services for a term extending from 22 May, 1997 to 22 May, 2000. The agreement has been extended three years to 22 May, 2003.

From January to December 2002, the amount incurred by the Group to Southern Airlines Advertising Company for advertising services was RMB3,275,000.

- (c) *Southern Airlines Group Finance Company Limited ("SA Finance") which is 42% owned by CSAHC, 30% owned by the Company, 28% owned in aggregate by six subsidiaries of the Company*

The Company has entered into a financial agreement dated 22 May, 1997, with SA Finance for the provision of financial services such as deposit and loan facilities, credit facilities, financial guarantees and credit references for a term commencing from 22 May, 1997 to 22 May, 2000. The agreement has been extended to 22 May, 2006.

Under such agreement, (a) all funds that the Company deposits with SA Finance will be deposited by SA Finance with the Industrial and Commercial Bank of China, Bank of Communications, Bank of Agriculture, China Construction Bank, or other banks of similar creditworthiness; and (b) SA Finance will not at any time have outstanding loans in excess of the amount representing the aggregate of (i) deposits received from entities other than the Company, (ii) SA Finance's shareholders' equity and (iii) capital reserves.

The Group had short-term deposits placed with SA Finance at 31 December, 2002 amounting to RMB900,979,000 which earned interest at the rate of 1.98%–3.00% per annum.

- (d) *Shenzhen Air Catering Company Limited, which is 33% owned by CSAHC, and 67% owned by two independent third parties*

The Company and Shenzhen Air Catering Company Limited have entered into an agreement dated 23 May, 1997 for the sale and purchase of in-flight meals for flights originating or stopping at the airport in Shenzhen. Pursuant to such agreement, Shenzhen Air Catering Company Limited will supply in-flight meals to the Group from time to time during the term from 23 May, 1997 to 23 May, 1998. The agreement has been extended by the parties to 23 May, 2003.

For the year ended 31 December, 2002, the amount paid by the Group to Shenzhen Air Catering Company Limited for the provision of in-flight meals was approximately RMB29,058,000.

- (e) *Guangzhou Aircraft Maintenance Engineering Company Limited ("GAMECO"), which is 50% owned by the Company and 50% owned by two independent third parties*

The Company and GAMECO have entered into an Aircraft Maintenance and Engineering Agreement for the provision of aircraft repair and maintenance services. On 17 May, 1996, the Company and GAMECO entered into an agreement regarding the fee arrangement for the provision of such repair and maintenance services (the "Fee Agreement"). Pursuant to the Fee Agreement and subsequent agreements, GAMECO charged the Company for expendables at cost plus 15%, and labour costs at US\$30.0 per hour during 2002.

For the year ended 31 December, 2002, the amount incurred by the Group for such repair and maintenance services was RMB592,311,000.

- (f) *China Southern West Australian Flying College Pty Ltd (the "Australian Pilot College"), which is 65% owned by the Company and 35% owned by CSAHC*

CSAHC and the Australian Pilot College entered into an agreement dated 7 October, 1993 for the provision of pilot training in Australia to the cadet pilots of CSAHC (the "Training Agreement"). The Training Agreement will remain in force unless terminated by either party upon 90 days' prior written notice to the other party. Pursuant to the Demerger Agreement, the Company has assumed

all the interests, rights and obligations of CSAHC under the Training Agreement.

For the year ended 31 December, 2002, the amount paid by the Group to the Australian Pilot College for training services was RMB56,342,000.

- (g) *Southern Airlines (Group) Economic Development Company, which is 61% owned by CSAHC and 39% owned by an independent third party*

The Company and Southern Airlines (Group) Economic Development Company have entered into an agreement dated 22 May, 1997, for the provision of drinks, snacks, liquor, souvenirs and other products for a term extending from 22 May, 1997 to 22 May, 2007.

For the year ended 31 December, 2002, the amount paid by the Group to Southern Airlines (Group) Economic Development Company for the provision of drinks, snacks, liquor, souvenirs and other products was RMB101,350,000.

- (h) *Guangzhou Nanland Air Catering Company Limited ("Nanland"), which is 51% owned by the Company and 49% owned by an independent third party*

The Company and Nanland have entered into a catering agreement dated 22 May, 1999 for the sale and purchase of in-flight meals for flights originating or stopping at the airport in Guangzhou. Pursuant to such agreement, Nanland will supply inflight meals to the Company

from time to time during the term from 22 May, 1999 to 22 May, 2000. The agreement will then be automatically extended annually.

For the year ended 31 December, 2002, the amount paid by the Group to Nanland for the provision of inflight meals was RMB88,911,000.

- (i) *Ticket sales arrangements*

The Group has entered into ticket agency agreements for the sale of the Group's air tickets with several subsidiaries of CSAHC (the "Agents"). The Agents charge commission on the basis of the rates stipulated by the CAAC and International Air Transport Association ("IATA"). The Agents charge a commission in the amount of 3% of the ticket price for domestic tickets and 5% to 12% of the ticket price for Hong Kong regional/international tickets. The Group has other air ticket sales agents in China who also charge commission at the same rates. The Agents also act as air ticket sales agents for other Chinese airlines and charge the same rates of commission to such other airlines as those charged to the Group.

For the year ended 31 December, 2002, the aggregate amount of ticket sales of the Group conducted through the Agents was RMB226,488,000.

(C) Trademark Licence Agreement

The Company and CSAHC have entered into a 10 year Trademark Licence Agreement dated 22 May, 1997 pursuant to which CSAHC acknowledges that the Company has the right

to use the name “China Southern” and “China Southern Airlines” in both Chinese and English, and grants to the Company a renewable royalty-free licence to use the kapok logo on a world-wide basis in connection with the Company’s airline and airline-related businesses. Unless CSAHC gives written notice of termination three months before the expiration of the agreement, the agreement will be automatically extended for another 10-year term.

(D) Leases

The Company as lessee and CSAHC as lessor have entered into the following lease agreements:

- (a) The Company and CSAHC have entered into a land lease agreement dated 22 May, 1997, in respect of the land used by the Company within Guangzhou Baiyun International Airport. The rental payment is RMB2,650,700 per year. The term of the lease is five years commencing 1 April, 1997 and is renewable by the parties thereafter (subject to mutual agreement with respect to rental terms).
- (b) The Company and CSAHC have separately entered into four lease agreements dated 22 May, 1997, in respect of office premises located at the east wing of the Guangzhou Railway Station on Guangzhou Huanshi Dong Road, office premises at Haikou Airport, office premises in Haikou City, and office premises at Tianhe Airport in Wuhan, Hubei Province. The aggregate rental payment under the four leases is RMB12,573,000 per year. The term of each lease is one year and is renewable

by the parties thereafter (subject to mutual agreement with respect to rental terms).

- (c) The Company and CSAHC have entered into an indemnification agreement dated 22 May, 1997 in which CSAHC has agreed to indemnify the Company against any loss or damage caused by or arising from any challenge of, or interference with, the Company’s right to use certain land and buildings.

(E) Comprehensive Services and Employee Benefits

The Company and CSAHC have entered into a comprehensive services agreement (the “Services Agreement”) dated 22 May, 1997.

The Services Agreement provides that CSAHC shall sell or rent housing to eligible employees of the Group at lower than market price. As the housing is sold or rented below cost and the construction costs of the leased housing were originally paid by CSAHC, the Company shall pay CSAHC RMB85 million per year, payable quarterly in arrears, for a term of ten years from 1995 to 2004.

(F) Ongoing Connected Transactions with Northern Airlines and Xinjiang Airlines

Northern Airlines

Northern Airlines is principally engaged in commercial airline services in the PRC with its headquarters based in Shenyang, East Northern part of the PRC. Following the consolidation and restructuring among CSAHC, Northern Airlines and Xinjiang Airlines as described in the

Company's announcement dated 11 October, 2002 (the "Consolidation and Restructuring"), Northern Airlines becomes a wholly owned subsidiary of CSAHC and therefore constitutes a connected person of the Company under the Listing Rules.

Xinjiang Airlines

Xinjiang Airlines is principally engaged in commercial airline services in the PRC with its headquarters based in Urumqi, Xinjiang. Following the consolidation and restructuring, Xinjiang Airlines becomes a wholly owned subsidiary of CSAHC and therefore constitutes a connected person of the Company under the Listing Rules.

(a) *In-flight Meals Arrangement with Northern Airlines, a wholly owned subsidiary of CSAHC*

Nanland has been providing and will provide in-flight meals to Northern Airlines. Pursuant to an agreement dated 23 June, 2000, Nanland has been providing in-flight meals to Northern Airlines from time to time for a period of one year. The agreement will then be automatically extended annually. For the year ended 31 December, 2002, the amount paid by Northern Airlines to Nanland for the provision of in-flight meals was approximately RMB4,413,000.

(b) Pursuant to an agreement dated 30 October, 2001, Northern Airlines has been providing and will provide in-flight meals to the Group from time to time for a period of one year. The agreement will then be automatically extended annually.

For the year ended 31 December, 2002, the amount paid by the Group to Northern Airlines for the provision of in-flight meals was approximately RMB2,539,000.

(c) *In-flight Meals Arrangement with Xinjiang Airlines, a wholly owned subsidiary of CSAHC*

Pursuant to an agreement dated 24 March, 2001, Nanland has been providing and will provide in-flight meals to the Xinjiang Airlines from time to time for a period of one year. The agreement will then be automatically extended annually.

For the year ended 31 December, 2002, the amount paid by Xinjiang Airlines to Nanland for the provision of in-flight meals was approximately RMB2,096,000.

(d) Pursuant to an agreement dated 20 September, 1999, Xinjiang Airlines has been providing and will provide in-flight meals to the Company for a period of one year. The agreement will then be automatically extended annually. The amount paid by the Group to Xinjiang Airlines for the provision of in-flight meals for the year ended 31 December, 2002 was approximately RMB1,067,000.

(e) *Ticket Sales Arrangement with Northern Airlines, a wholly owned subsidiary of CSAHC*

In accordance with the relevant requirement and industry practice, the Group has entered into ticket agency arrangement with Northern Airlines for the sale of the Group's air tickets by Northern

Airlines and for the sale of Northern Airlines air tickets by the Group. The selling party charges a commission in the amount of 3% of the ticket price for domestic tickets and 5% to 12% of the ticket price for Hong Kong regional and international tickets. These commission rates are based on the rates stipulated by the CAAC and IATA. The amount of commission paid by Northern Airlines to the Group for the year ended 31 December, 2002 was approximately RMB1,516,000. The amount of commission paid by the Group to Northern Airlines for the year ended 31 December, 2002 was approximately RMB554,000.

The amounts payable under the above aforesaid transactions are based on the rates stipulated by the CAAC and IATA.

(f) *Ticket Sales Arrangement with Xinjiang Airlines, a wholly owned subsidiary of CSAHC*

The Group has entered into ticket agency arrangement with Xinjiang Airlines for the sale of the Group's air tickets by Xinjiang Airlines and for the sale of Xinjiang Airlines air tickets by the Group. The selling party charges a commission in the amount of 3% of the ticket price for domestic tickets

and 5% to 12% of the ticket price for Hong Kong regional and international tickets. These commission sales are based on the rates stipulated by the CAAC and IATA. The amount of commission paid by Xinjiang Airlines to the Group for the year ended 31 December, 2002 was approximately RMB449,000. The amount of commission paid by the Group to Xinjiang Airlines for the year ended 31 December, 2002 was approximately RMB199,000.

The amount payable under the above aforesaid transactions are based on the rates stipulated by the CAAC and IATA.

(g) In November 2002, the Hong Kong Stock Exchange granted a waiver in relation to the in-flight meals and ticket sales arrangements between the Group and CSAHC after approval of the consolidation and restructuring proposal of the PRC aviation industry by the State Council of the PRC (the "Ongoing Connected Transactions for In-Flight meals and Ticket Sales").

The Hong Kong Stock Exchange has granted the waiver on and subject to the following conditions:

1. the Ongoing Connected Transactions for In-flight Meals and Ticket Sales shall be:
 - (a) entered into in the ordinary and usual course of business of the Group;
 - (b) conducted either on normal commercial terms or on terms no less favourable than terms available to (or from, as appropriate) independent third parties; and
 - (c) on terms that are fair and reasonable so far as the shareholders of the Company and in the interest of the Company as a whole are concerned;



2. the aggregate annual amount payable by the Group to CSAHC, and the aggregate annual amount payable by CSAHC to the Group, under the On going Connected Transactions for In-Flight Meals and Ticket Sales for each financial year have will not exceeded the higher of HK\$10 million and 3% of the consolidated net tangible assets of the Company as disclosed in its latest published audited accounts (the "Relevant Cap Amount");
3. the details of the On going Connected Transactions for In-Flight Meals and Ticket Sales will be disclosed in the Company's annual report as set out in Rule 14.25(1)(A) to (D) of the Listing Rules for the relevant financial year of the Company;
4. the independent non-executive directors will review annually and confirm in the Company's annual report of the relevant financial year that the On going Connected Transactions for In-Flight Meals and Ticket Sales have been conducted in the manner as stated in paragraph 1 above and comply with the Relevant Cap Amount as stated in paragraph 2 above;
5. the auditors of the Company shall review annually the transactions and provide a letter to the Board of Directors stating that:
 - (a) the Ongoing Connected Transactions for In-Flight Meals and Ticket Sales have

received approval of the Board of Directors of the Company;

- (b) the Ongoing Connected Transactions for In-Flight Meals and Ticket Sales have been entered into in accordance with the terms of the agreements relating to the transactions;
- (c) the aggregate annual amount payable by the Group to CSAHC, and the aggregate annual amount payable by CSAHC to the Group, under the Ongoing Connected Transactions for In-Flight Meals and Ticket Sales for each financial year shall not exceed the Relevant Cap Amount set out in paragraph 2 above; and
- (d) the Ongoing Connected Transactions for In-Flight Meals and Ticket Sales are in accordance with the pricing policy of the Group.

Where, for whatever reasons, the auditors decline to accept the engagement or are unable to provide the auditors' letter, the Directors shall contact the Hong Kong Stock Exchange immediately.

- 6. CSAHC shall provide to the Hong Kong Exchange an undertaking that, for so long as the Company's shares are listed on the Hong Kong

Stock Exchange, it will provide the Company's auditors with full access to its relevant records for the purpose of the auditors' review of the Ongoing Connected Transactions for In-Flight Meals and Ticket Sales.

- (h) As CSAHC is the 65.2% controlling shareholder of the Company, each of the eight revenue sharing scheme agreements entered into between the Company, Northern Airlines and Xinjiang Airlines (the "RSSA") where Northern Airlines and Xinjiang Airlines are the relevant parties will constitute a connected transaction under the Listing Rules. The major terms of each RSSA are similar and are briefly described as follows:

1. Revenue arising from those routes covered under the RSSA will be allocated in proportion to the traffic capacity, calculated by reference to the model of the aircraft, frequency of the flights and also the seats capacity, deployed by the respective parties to the RSSA respectively. The allocation of the revenue is not ascertainable until the end of each month during the term of the respective RSSA.
2. The traffic capacity is determined by the respective airlines. The corresponding operating costs will be borne by the respective parties to the RSSA.

3. The revenue derived from those routes covered under the RSSA will be collected by the respective parties to the RSSA independently ("Actual Revenue"). At the end of the term of the RSSA, Actual Revenue of the respective parties to the RSSA will be aggregated and calculated under the terms of the RSSA. The amount of revenue attributable to each party according to the terms of the RSSA will be allocated among the respective parties to the RSSA in proportion to the monthly seat capacity of the parties ("Allocated Revenue"). Any Allocated Revenue in excess of the Actual Revenue collected by any parties under the RSSA will be allocated to such parties. The tickets will be sold by the respective parties to the RSSA under their respective codes.

4. The scheme has the beneficial effect of protecting the interests of the parties to the RSSA in the operation of the routes covered under the RSSA.

5. There is no consideration payable by the parties in entering into the RSSA.

6. Each of the RSSA will be effective from 1 December, 2002 to 29 March, 2003. At the end of the term, the parties to the respective RSSA can renew the term on the same terms as the RSSA or amend the terms of the RSSA. If and when

there are any amendments to the terms of the RSSA, the Company will comply with the Listing Rules requirements.

Reasons for the Ongoing Transactions

It is expected that by entering into the RSSA, adverse price competition of the routes covered under the RSSA can be avoided to certain extent and the effect of which is to protect the interest of each party to the RSSA.

In December 2002, the Hong Kong Stock Exchange granted a waiver in relation to the eight RSSA between the Company, Northern Airlines and Xinjiang Airlines relating to eight domestic routes (the "Ongoing Connected Transactions for Revenue sharing").

The Hong Kong Stock Exchange has granted the Waiver on and subject to the following conditions:

1. the Ongoing Connected Transactions for Revenue Sharing shall be:
 - (a) entered into in the ordinary and usual course of business of the Group;
 - (b) conducted either on normal commercial terms or on terms no less favourable than terms available from independent third parties; and
 - (c) entered into in accordance in the relevant agreements and on terms that are fair and reasonable so far as the shareholders of the Company are concerned and in the interest of the Company as a whole;

2. the aggregate amount payable by the Group to Northern Airlines and Xinjiang Airlines (as appropriate) and by Northern Airlines and Xinjiang Airlines (as appropriate) to the Group under the RSSA for each financial year will not exceed the higher of HK\$10 million and 3% of the consolidated net tangible assets of the Company as disclosed in its latest published audited accounts (the "Relevant Cap Amount for Revenue Sharing");
3. the details of the Ongoing Connected Transactions for Revenue Sharing will be disclosed in the Company's annual report as set out in Rule 14.25(1)(A) to (D) of the Listing Rules for the relevant financial year of the Company;
4. the independent non-executive directors will review annually and confirm in the Company's annual report of the relevant financial year that the Ongoing Connected Transactions for Revenue Sharing have been conducted in the manner as stated in paragraph 1 above and comply with the Relevant Cap Amount for Revenue Sharing as stated in paragraph 2 above;
5. the auditors of the Company shall review annually the Ongoing Connected Transactions for Revenue Sharing and provide a letter to the Board of Directors stating that:
 - (a) the Ongoing Connected Transactions for Revenue Sharing have received approval of the Board of Directors of the Company;
 - (b) the Ongoing Connected Transactions for Revenue Sharing have been entered into in accordance with the terms of the agreements relating to the transactions;
 - (c) the aggregate amount payable by the Group to Northern Airlines and Xinjiang Airlines (as appropriate) and by Northern Airlines and Xinjiang Airlines (as appropriate) to the Group under the RSSA for each financial year will not exceed the Relevant Cap Amount for Revenue Sharing set out in paragraph 2 above; and
 - (d) the Ongoing Connected Transactions for Revenue Sharing are in accordance with the pricing policy of the Group.

Where, for whatever reasons, the auditors decline to accept the engagement or are unable to provide the auditors' letter, the Directors shall contact the Hong Kong Exchange immediately; and



6. Northern Airlines and Xinjiang Airlines shall provide to the Hong Kong Stock Exchange an undertaking that, for so long as the Company's shares are listed on the Hong Kong Stock Exchange, it will provide the Company's auditors with full access to their relevant records for the purpose of the auditors' review of the Ongoing Connected Transactions for Revenue Sharing .

For the year ended 31 December, 2002, the aggregate amounts payable by the Group to Northern Airlines and Xinjiang Airlines under the RSSA amounted to RMB1,408,000 and the aggregate amounts payable by Northern Airlines and Xinjiang Airlines to the Group amounted to RMB238,000 and RMB1,170,000

The Independent Non-Executive Directors of the Company have confirmed to the Board of Directors of the Company that they have reviewed the connected transactions described in (B) through (F) above and have concluded that:

- (a) the transactions have been entered into by the Group in the ordinary and usual course of its business;
- (b) the transactions have been entered into either (A) on normal commercial terms (by reference to transactions of a similar nature made by similar entities within the PRC) or (B) (where there is no available comparison) on terms that are fair and reasonable so far as the shareholders of the Company are concerned;
- (c) the transactions have been performed either (A) in accordance with the terms of the agreement governing each such transaction or (B) (where there is no such agreement) on terms no less favourable than terms available from third parties; and

- (d) the aggregate annual amount payable by the Group to CSAHC, and the aggregate annual amount payable by CSAHC to the Group, under the On going Connected Transactions for In-Flight Meals and Ticket Sales for each financial year have not exceeded the higher of HK\$10 million and 3% of the consolidated net tangible assets of the Company as disclosed in its latest published audited accounts.

Waiver from the Stock Exchange of Hong Kong Limited

In March 2002, the Hong Kong Stock Exchange granted a waiver to allow the Company to use a new size test based on available tonne kilometres ("ATKs") to replace the normal net asset test and consideration test under Chapter 14 of the Listing Rules in respect of acquisitions and disposals of aircraft.

The Hong Kong Stock Exchange has granted the waiver on and subject to the following conditions:

- 1. Instead of the normal tests under Chapter 14 of the Listing Rules, the tests may be calculated by reference to the ATKs for aircraft being acquired or disposed of as compared to the Company's aggregate fleet ATKs.
- 2. The proposed method of calculation for the four tests will replace the net asset test and the consideration test only while the other two tests, namely, net profit and equity capital issued tests will continue to apply as set out in Chapter 14 of the Listing Rules.
- 3. The calculation of ATKs will be as follows:
 - i) fleet ATKs will be the aggregate actual ATKs for all aircraft in the Company's fleet for the last financial year as disclosed in the Company's annual report, ii) ATKs for

aircraft being disposed of will be based on actual ATKs of the aircraft for the previous two financial years; and iii) ATKs for aircraft being acquired will be based on the historical operating data for the same type of aircraft. Where the aircraft to be acquired is a new type, the ATKs will be estimated based on other aircraft of similar size operated by the Company or the average for the Chinese civil aviation industry.

4. The Company's ATKs figure will be disclosed in the Company's annual report and be reviewed by auditors who will confirm on an annual basis that the Company's ATKs are calculated correctly and consistently.
5. For the purposes of making the test as stated in paragraph 1 above, all acquisitions and disposals for the last 12 months will be aggregated, unless the acquisition or disposal has previously been reported as a notifiable transaction under these rules.
6. The thresholds for classifying a transaction as a discloseable, major or very substantial acquisition will be 30%, 50% and 100% (assuming that there are no circumstances which would make it a connected transaction or a share transaction).
7. Where the transaction is a discloseable transaction, disclosure will take the form of a press announcement complying with rule 14.14 of the Listing Rules and details of the transaction will be set out in the Company's next annual report and accounts. Where the transaction is a major transaction or a very substantial acquisition, the provisions of Chapter 14 of the Listing Rules will apply.
8. An option to acquire aircraft will not be treated as acquisition while the exercise of such an option will be treated as acquisition of aircraft.
9. The waiver will only apply to acquisition/disposal of aircraft, and acquisition or disposal of other types of assets by the Company will be subject to provisions under Chapter 14 of the Listing Rules.
10. The Company will disclose in its annual reports and interim reports the following information:
 - (a) regarding future deliveries of aircraft, details of aircraft on order including the number and type; and the years in which such aircraft are scheduled to be delivered;
 - (b) the number and type of aircraft which are subject to options exercisable during a period of not less than 12 months from the end of the financial year or period to which the annual report relates; and
 - (c) details of the waiver granted pursuant to the application.

11. The Company remains a subsidiary of the CSAHC. Should there be any change in control of the Company, the Hong Kong Stock Exchange will need to reconsider whether the waiver continues to be appropriate.

Regarding future deliveries of aircraft, details of aircraft on order and the years in which such aircraft are scheduled to be delivered, please refer to note 29 to the financial statements. Three Boeing 757-200 aircraft were subject to options exercisable and had been exercised during the period to which this annual report relates.

Donations

During the year, the Group made donations for charitable purposes amounting to RMB1.4 million (2001: RMB1.4 million).

Designated Deposits and Overdue Time Deposits

As at 31 December, 2002, the Group's deposits placed with financial institutions or other parties did not include any designated deposits, or overdue time deposits against which the Group failed to receive repayments.

Material Litigation

The Group was not involved in any material litigation or dispute in 2002.

Auditors

A resolution is to be proposed at the forthcoming Annual General Meeting of the Company for the reappointment of KPMG as the international auditors of the Company and of KPMG Huazhen as the PRC auditors of the Company.

By Order of the Board of Directors
Yan Zhi Qing
Chairman of the Board of Directors

Guangzhou, the PRC
14 March, 2003