

Report of the Directors

The board of directors ("Board") of the Company hereby presents this Annual Report and the audited financial statements for the year ended 31 December 2005.

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 2005, 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 financial statements for the year ended 31 December 2005 and the financial position of the Company and the Group as of that date in accordance with International Financial Reporting Standards ("IFRSs") and PRC Accounting Rules and Regulations. See pages 39 to 182 of this Annual Report.

FIVE-YEAR SUMMARY

A summary of the results and the assets and liabilities of the Group prepared under IFRS for the five-year period ended 31 December 2005 are set out on pages 186 and 187 of this Annual Report.

DIVIDENDS

No interim dividend was paid during the year ended 31 December 2005 (2004: Nil).

The Board of the Company does not recommend the payment of a final dividend in respect of the year ended 31 December 2005 (2004: Nil).

BANK LOANS AND OTHER BORROWINGS

Details of the bank loans and other borrowings of the Company and the Group are set out in notes 30 and 31 to the financial statements prepared under IFRS.

INTEREST CAPITALISATION

For the year ended 31 December 2005, RMB98 million (2004: RMB34 million) 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 2005 are set out in note 18 to the financial statements prepared under IFRS.

MAJOR CUSTOMERS AND SUPPLIERS

The percentage of turnover attributable to the Group's five largest customers in aggregate was less than 30% of the Group's total operating revenue (i.e. turnover) for the year ended 31 December 2005.

The percentage of purchases attributable to the largest supplier and the five largest suppliers in aggregate represented approximately 80% and 89% respectively of the Group's total purchases (not including purchases of items which are of a capital nature) for the year ended 31 December 2005.

At no time during the year have the Directors, their associates or any shareholder of the Company (which to the knowledge of the Directors owns more than 5% of the Company's share capital) had any interest in the Group's five largest customers or suppliers.

Report of the Directors (Cont'd)



TAXATION

Details of taxation of the Company and the Group are set out in notes 14 and 24 to the financial statements prepared under IFRS.

RESERVES

Movements in the reserves of the Company and the Group during the year are set out in note 38 to the financial statements prepared under IFRS.

EMPLOYEES AND EMPLOYEES' PENSION SCHEME

As at 31 December 2005, the Group had an aggregate of 34,417 employees (2004: 18,221). Details of the employees' retirement and housing benefits are set out in notes 11 and 40 to the financial statements prepared under IFRS.

SUBSIDIARIES

Details of the principal subsidiaries of the Company are set out in note 51 to the financial statements prepared under IFRS.

SHARE CAPITAL STRUCTURE

Change in Share Capital

There was no change in the share capital of the Company for the year ended 31 December 2005.

Share Capital Structure

| Type of shares | Number of shares | Approximate percentage of total share capital (%) |
|---|------------------|---|
| 1. Unlisted shares | | |
| State-owned shares | 2,200,000,000 | 50.30 |
| 2. Listed shares | | |
| 1. Overseas listed ordinary shares (H Shares) | 1,174,178,000 | 26.84 |
| 2. Domestic listed ordinary shares (A Shares) | 1,000,000,000 | 22.86 |
| Total share capital | 4,374,178,000 | 100.00 |

Report of the Directors (Cont'd)

SUBSTANTIAL SHAREHOLDERS

As at 31 December 2005 so far as was known to the Directors and supervisors (the "Supervisors") of the Company, the interests and short positions of the following persons other than the Directors or Supervisors of the Company in the shares and underlying shares of the Company which would fall to be disclosed to the Company under the provisions of Divisions 2 and 3 of Part XV of the Securities and Futures Ordinance (the "SFO") or who were, directly or indirectly, interested in 10% or more of the nominal value of any class of share capital carrying rights to vote in all circumstances at general meeting of any other members of the Group, or had any option in respect of such capital are set out below:

| Name of shareholders | Type of shareholding | Type of shares | Number of shares held | % of the total issued H shares of the Company | % of the total issued domestic shares of the Company | % of the total issued share capital of the Company | Short position |
|------------------------|----------------------|-------------------------------|-----------------------|---|--|--|----------------|
| CSAHC | Direct holding | State-owned shares (A Shares) | 2,200,000,000 | – | 68.75% | 50.30% | – |
| HKSCC Nominees Limited | Direct holding | H Shares | 1,150,438,998 | 97.98% | – | 26.30% | – |

Notes:

Based on the information available to the Directors and Supervisors of the Company (including such information as was available on the website of The Stock Exchange of Hong Kong Limited (the "Hong Kong Stock Exchange") and so far as the Directors and Supervisors are aware, as at 31 December 2005:

1. Among the 1,150,438,998 H Shares held by HKSCC Nominees Limited, Li Ka-Shing Unity Trustcorp Limited had an interest in an aggregate of 193,877,000 H Shares of the Company (representing approximately 16.51% of its then total issued H Shares) in the capacity as beneficiary of a trust.
2. Among the 1,150,438,998 H Shares held by HKSCC Nominees Limited, JPMorgan Chase & Co. had an interest in an aggregate of 138,623,000 H Shares of the Company (representing approximately 11.81% of its then total issued H Shares). Out of the 138,623,000 H Shares, JPMorgan Chase & Co. had an interest in a lending pool comprising 26,133,000 H Shares of the Company (representing approximately 2.23% of its then total issued H Shares). According to the information as disclosed in the website of the Hong Kong Stock Exchange and so far as the Directors and Supervisors are aware, JPMorgan Chase & Co. held its interest in the Company in the following manners:
 - (a) 26,133,000 H Shares in a lending pool, representing approximately 2.23% of the Company's then total issued H Shares, were held by J.P. Morgan Chase Bank, N.A. which was 100% held by JPMorgan Chase & Co.;
 - (b) 192,000 H Shares, representing approximately 0.02% of the Company's then total issued H Shares, were held in the capacity as beneficial owner by J.P. Morgan Whitefriars Inc., which was ultimately 100% held by JPMorgan Chase & Co.; and
 - (c) 112,298,000 H Shares, representing approximately 9.56% of the Company's then total issued H Shares, were held in the capacity as investment manager by JF Asset Management Limited, which was approximately 99.99% held by J.P. Morgan Fleming Asset Management (Asia) Inc., which was ultimately 100% held by JPMorgan Chase & Co.

Report of the Directors (Cont'd)



3. Among the 1,150,438,998 H Shares held by HKSCC Nominees Limited, Morgan Stanley International Incorporated had an interest in an aggregate of 111,121,932 H Shares of the Company (representing approximately 9.46% of its then total issued H Shares). According to the information as disclosed on the website of the Hong Kong Stock Exchange and so far as the Directors and Supervisors are aware, Morgan Stanley International Incorporated which was (or its directors were) accustomed to act in accordance with the directors of Morgan Stanley, held its indirect interest in the Company as at 31 December 2005 in the manner as follows:
- (a) 743,322 H Shares, representing approximately 0.06% of the Company's then total issued H Shares, were held by Morgan Stanley Dean Witter Hong Kong Securities Limited, which was ultimately 100% held by Morgan Stanley Asia Pacific (Holdings) Limited, which, in turn, was 90% held by Morgan Stanley International Incorporated;
 - (b) 108,670,000 H Shares, representing approximately 9.25% of the Company's then total issued H Shares, were held by Morgan Stanley Investment Management Company, which was ultimately 100% held by Morgan Stanley Asia Pacific (Holdings) Limited, which, in turn, was 90% held by Morgan Stanley International Incorporated;
 - (c) 292,600 H Shares, representing approximately 0.02% of the Company's then total issued H Shares, were held by Morgan Stanley Asset & Investment Trust Management Co. Limited, which was 100% held by Morgan Stanley International Incorporated;
 - (d) 714,000 H Shares, representing approximately 0.06% of the Company's then total issue H Shares, were held by Morgan Stanley & Co International Limited, which was ultimately 100% held by Morgan Stanley Group (Europe), which, in turn, was approximately 98.30% held by Morgan Stanley International Limited, in which Morgan Stanley International Incorporated held 100% control; and
 - (e) 702,000 H Shares, representing approximately 0.06% of the Company's then total issued H Shares, were held by Morgan Stanley Capital (Luxembourg) S.A., which was approximately 93.75% held by Morgan Stanley International Incorporated.

According to the information as disclosed on the website of the Hong Kong Stock Exchange and so far as the Directors and Supervisors are aware, as at 31 December 2005, Morgan Stanley Dean Witter Hong Kong Securities Limited also had a short position in 616,000 H Shares of the Company (representing approximately 0.05% of its then total issued H Shares).

4. Among the 1,150,438,998 H Shares held by HKSCC Nominees Limited, 96,938,500 H Shares, representing approximately 8.26% of the Company's then total issued H Shares, were held by Space Dragon Limited as beneficial owner, which was 100% held by Cheung Kong Investment Company Limited.
5. Among the 1,150,438,998 H Shares held by HKSCC Nominees Limited, 96,938,500 H Shares, representing approximately 8.26% of the Company's then total issued H Shares, were held by Choicewell Limited as beneficial owner, which was ultimately 100% held by Hutchison Whampoa Limited.

Save as disclosed above, as at 31 December 2005, so far as was known to the Directors and Supervisors of the Company, no other person (other than the Directors or Supervisors) had an interest or short position in the shares or underlying shares of the Company under the provisions of Divisions 2 and 3 of Part XV of the SFO or who were, directly or indirectly, interested in 10% or more of the nominal value of any class of share capital carrying rights to vote in all circumstances at general meeting of any other members of the Group.

Report of the Directors (Cont'd)

PARTICULARS OF SHAREHOLDERS

The total number of shareholders of the Company as at 31 December 2005 was 126,269, of which 124,154 were shareholders of A Shares and 2,115 were shareholders of H Shares.

Particulars of shareholdings of the Company's ten largest shareholders as at 31 December 2005 are as follows:

Shareholdings of ten largest shareholders

| Name of shareholders | Movement during the year increase/ (decrease) (shares) | Total number of shares held at 31 December 2005 (shares) | Percentage (%) | Type of shares | Pledged or frozen shares | Type of shares held |
|---|--|--|----------------|----------------|--------------------------|---------------------|
| CSAHC | 0 | 2,200,000,000 | 50.3 | Unlisted | Nil | State-owned shares |
| HKSCC Nominees Limited | (1,515,000) | 1,150,438,998 | 26.3 | Listed | Unknown | H Shares |
| Jingfu Securities Investment Fund | 32,402,674 | 35,615,472 | 0.8 | Listed | Unknown | A Shares |
| The Industrial and Commercial Bank of China – Shangzheng 50 Trading and Open Index Fund | 23,636,246 | 30,619,046 | 0.7 | Listed | Unknown | A Shares |
| Bank of China – Haifutong Return Growth Securities Investment Fund | 21,051,290 | 21,051,290 | 0.5 | Listed | Unknown | A Shares |
| Bank of Communications – Yi Fang Da 50 Index Securities Investment Fund | (1,168,641) | 20,856,113 | 0.5 | Listed | Unknown | A Shares |
| Bank of Communications – Ke Rui Securities Investment Fund | 15,668,439 | 15,668,439 | 0.4 | Listed | Unknown | A Shares |
| Bank of Communications – Han Xing Securities Investment Fund | 3,000,804 | 13,800,804 | 0.3 | Listed | Unknown | A Shares |
| The Industrial and Commercial Bank of China – BOC International China Selected Portfolio Securities Investment Fund | 13,463,237 | 13,463,237 | 0.3 | Listed | Unknown | A Shares |
| Jing Ye Securities Investment Fund | 10,775,280 | 13,121,385 | 0.3 | Listed | Unknown | A Shares |

PURCHASE, SALE OR REDEMPTION OF SHARES

Neither the Company nor any of its subsidiaries purchased, sold or redeemed any shares of the Company during the year ended 31 December 2005.

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.

AUDIT COMMITTEE

The audit committee of the Company has reviewed and confirmed this Annual Report.

Report of the Directors (Cont'd)



THE MODEL CODE

Having made specific enquiries with all the Directors of the Company, the Directors have for the year ended 31 December 2005 complied with the Model Code for Securities Transactions by Directors of Listed Issuers as set out in Appendix 10 of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the "Listing Rules"). The Company has not adopted a code of conduct less stringent than the Model Code for Securities Transactions by Directors of Listed Issuers regarding securities transactions of the Directors.

COMPLIANCE WITH THE CODE PROVISIONS OF THE CODE ON CORPORATE GOVERNANCE PRACTICES

In the opinion of the Directors of the Company, the Group has complied with the code provisions of the Code on Corporate Governance Practices set out in Appendix 14 of the Listing Rules issued by the Hong Kong Stock Exchange throughout the year ended 31 December 2005.

DIRECTORS, SUPERVISORS AND SENIOR ADMINISTRATIVE OFFICERS

Directors, Supervisors and senior administrative officers of the Company in 2005 were as follows:

| Name | Position | Gender | Age |
|-------------------------------|--|--------|-----|
| Liu Shao Yong | Chairman of the Board | Male | 48 |
| Liu Ming Qi ⁽¹⁾ | Vice Chairman of the Board | Male | 62 |
| Peng An Fa ⁽²⁾ | Director | Male | 58 |
| Wang Quan Hua | Director | Male | 52 |
| Zhao Liu An | Director | Male | 58 |
| Zhou Yong Qian ⁽³⁾ | Director | Male | 61 |
| Si Xian Min | Director, President | Male | 49 |
| Zhou Yong Jin ⁽¹⁾ | Director | Male | 63 |
| Xu Jie Bo | Director, Chief Financial Officer and Vice President | Male | 41 |
| Wu Rong Nan ⁽¹⁾ | Director | Male | 64 |
| Simon To ⁽⁴⁾ | Independent Non-executive Director | Male | 55 |
| Peter Lok | Independent Non-executive Director | Male | 70 |
| Wei Ming Hai | Independent Non-executive Director | Male | 42 |
| Wang Zhi | Independent Non-executive Director | Male | 64 |
| Sui Guang Jun | Independent Non-executive Director | Male | 45 |
| Sun Xiao Yi | Chairman of the Supervisory Committee | Male | 52 |
| Yang Guang Hua | Supervisor | Male | 53 |
| Yang Yi Hua | Supervisor | Female | 46 |
| Li Kun ⁽⁵⁾ | Vice President | Male | 46 |
| Yuan Xin An | Vice President | Male | 49 |
| Zheng En Ren ⁽⁶⁾ | Vice President | Male | 61 |
| Hao Jian Hua | Vice President | Male | 55 |
| Ren Ji Dong ⁽⁷⁾ | Vice President | Male | 41 |
| He Zong Kai ⁽⁷⁾ | Vice President | Male | 55 |
| Liu Qian | Chief Pilot | Male | 40 |
| Su Liang | Company Secretary | Male | 44 |
| Chen Wei Hua | General Counsel | Male | 40 |

Report of the Directors (Cont'd)

- (1) The resignation of Liu Ming Qi, Zhou Yong Jin and Wu Rong Nan as Directors due to their retirement was approved at the first and second extraordinary general meetings of the Company on 16 December 2005;
- (2) The removal of Peng An Fa as Director of the Company owing to his suspected crime was discussed and approved at the first extraordinary general meeting of the Company on 16 December 2005;
- (3) Zhou Yong Qian resigned as Director of the Company due to his retirement. His resignation has been submitted by the Board of the Company for approval at the 2005 annual general meeting of the shareholders;
- (4) The resignation of Simon To as independent non-executive Director upon the expiry of his six years' term was approved at the second extraordinary general meeting of the Company on 16 December 2005;
- (5) Li Kun was relocated to other position and his resignation as Vice President of the Company was approved by the Board of the Company;
- (6) The resignation of Zheng En Ren as Vice President of the Company due to his retirement was approved by the Board of the Company; and
- (7) The appointment of Ren Ji Dong and He Zong Kai as vice presidents of the Company were approved by the Board on 29 March 2005.

Biographical details of the Board of Directors, senior administrative officers and members of the Supervisory Committee are set out on pages 188 to 191 of this Annual Report.

Report of the Directors (Cont'd)



INTERESTS AND SHORT POSITIONS OF DIRECTORS AND SUPERVISORS IN THE COMPANY AND ASSOCIATED CORPORATIONS

As at 31 December 2005, none of the Directors or Supervisors of the Company and their respective associates had interests or short positions in the shares, underlying shares and/or debentures (as the case may be) of the Company or its associated corporations (within the meaning of Part XV of the SFO) which were notified to the Company and the Hong Kong Stock Exchange pursuant to Divisions 7 and 8 of Part XV of SFO (including interests or short positions which are taken or deemed to have under such provisions of the SFO), or recorded in the register maintained by the Company pursuant to Section 352 of the SFO or which were notified to the Company and the Hong Kong Stock Exchange pursuant to the Model Code for Securities Transactions by Directors of the Listed Issuers in Appendix 10 of the Listing Rules.

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 June 2004 (except that the service contracts of Liu Shao Yong and Si Xian Min which commenced on 29 November 2004 and 31 December 2004 respectively will expire at the end of the term for the current session of the Board). Except for such service contracts, none of the Directors or Supervisors of the Company or its subsidiaries has entered or proposed to enter into any 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.

SUFFICIENT PUBLIC SHAREHOLDERS

According to the information obtained by the Company through public channels, and so far as the Directors are aware of as at the latest practicable date before the publishing of this Annual Report, the Company has been maintaining sufficient public shareholders to comply with the Listing Rules during the year.

INTERESTS OF DIRECTORS AND SUPERVISORS IN CONTRACTS

During the year ended 31 December 2005, none of the Directors or 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.

Report of the Directors (Cont'd)

CONNECTED TRANSACTIONS

The Company enters into certain connected transactions with CSAHC and other connected persons from time to time. Such transactions fall within the definition of connected transactions set out in Chapter 14A of the Listing Rules of the Hong Kong Stock Exchange. Details of such transactions conducted during the year and/or the related agreements entered into between the Company and such parties are disclosed as follows:

(A) De-merger Agreement

The De-merger 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 De-merger Agreement, CSAHC and the Company have agreed to indemnify the other party against claims, liabilities and expenses incurred by such other party relating to the businesses, assets and liabilities held or assumed by CSAHC or the Company (as the case may be) pursuant to the De-merger Agreement.

Neither the Company nor CSAHC has made any payments in respect of such indemnification obligations from the date of the De-merger Agreement up to the date of this report.

(B) Continuing Connected Transactions Between the Company, CSAHC (or Their Respective Subsidiaries)

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 ("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, New York Stock Exchange and Shanghai Stock Exchange. At present, the Company and CSAHC (or their respective subsidiaries) have entered into the following agreements:

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

The Company and SAIETC 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 from 22 May 1997 to 22 May 2000 which was subsequently extended to 22 May 2006 by mutual agreement between the parties. The parties have determined the various rates for import and export services provided by SAIETC after negotiations on a fair and equitable basis, which are not higher than the market rates for similar services.

For the year ended 31 December 2005, the amount incurred by the Group for the import and export of the above equipment was RMB31,714,000.

- (2) Southern Airlines Advertising Company, which is 45% owned by the Company and 55% owned by CSAHC ("SAAC")

The Company and SAAC 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. After extension of three years, the parties have mutually agreed to extend the agreement for another three years to 22 May 2006.

Under the agreement, SAAC will produce advertisement script, graphic and music to the Company with the copyright of such products belonging to the Company. The parties have determined the various rates for providing advertising services after negotiations on a fair and equitable basis, which are not higher than the market rates for similar services.

Report of the Directors (Cont'd)



For the year ended 31 December 2005, the amount incurred by the Group to SAAC for advertising services was RMB3,062,000.

- (3) China Southern Airlines Group Finance Company Limited ("SA Finance") which is 42% owned by CSAHC, 32% owned by the Company and 26% owned in aggregate by five subsidiaries of the Company

The Company 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. As agreed by the parties, the agreement was extended for six years to 22 May 2006. In order to comply with the new requirements under the Listing Rules, so that SA Finance can continue to provide deposit of money service and other financial services (subject to execution of separate agreements and further compliance with the Listing Rules), the Company and SA Finance entered into a new financial agreement on 12 November 2004, commencing from that date for a period of three years, and is renewable, subject to compliance with the requirements of the relevant Listing Rules by the Company, by an application in writing by the Company not less than 30 days before the end of the fixed term.

As SA Finance is a connected person of the Company under the Listing Rules, the financial agreement constitutes a discloseable and non-exempt continuing connected transaction under Rule 14A.35 of the Listing Rules and requires the Company to comply with the reporting and announcement requirement and the independent shareholders' approval requirement under Rule 14A.48 of the Listing Rules. The independent shareholders of the Company approved the financial agreement at the second extraordinary general meeting of the Company held on 31 December 2004.

Under such agreement, SA Finance agrees to provide to the Company the following financial services:

accept deposit of money from the Company at interest rates not lower than those set by the People's Bank of China for the same term of deposit. SA Finance will in turn deposit the whole of such sums of money with certain banks including Bank of Agriculture, Bank of Communications, China Construction Bank and Industrial and Commercial Bank of China;

make loans to the Company subject to the entering into of separate loan agreements, which will set out the maximum aggregate annual value ("Cap"), terms and conditions of the loans, upon application by the Company during the term of the financial agreement. The maximum limit for amount of money deposit under the financial agreement is RMB1 billion. The Company will comply with the Listing Rules when entering into such separate written agreements. SA Finance shall not charge interest rates higher than those set by the People's Bank of China for similar loans. The total amount of outstanding loans extended by SA Finance to the Company must not exceed the sum of SA Finance's shareholders' equity, capital reserves and money deposit received from other parties (except the Company); and

provide credit facilities, financial guarantees, credit references, and other financial services subject to the entering into of separate agreements, which will set out the cap, terms and conditions of such services, upon request by the Company during the term of the financial agreement. The Company will comply with the Listing Rules when entering into such separate written agreements.

As of 31 December 2005, the Group's deposits placed with SA Finance amounted to RMB543,825,000, which bore interest at the rate of 0.72% per annum; the balance of the loans extended to the Group by SA Finance amounted to RMB300,000,000.

Report of the Directors (Cont'd)

- (4) 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 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 parties have mutually agreed that the agreement can be renewed automatically.

For the year ended 31 December 2005, the amount incurred by the Group to Shenzhen Air Catering Company Limited for the provision of in-flight meals was approximately RMB60,542,000.

- (5) 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 De-merger Agreement, the Company has assumed all the interests, rights and obligations of CSAHC under the Training Agreement.

For the year ended 31 December 2005, the amount paid by the Group to the Australian Pilot College for training services was RMB81,471,000.

- (6) 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 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 2005, 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 RMB87,521,000.

- (7) 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 and Macau 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. The rates of commission are not higher than market rates for similar services.

For the year ended 31 December 2005, the aggregate amount of ticket sales of the Group conducted through the Agents was RMB451,121,000.

Report of the Directors (Cont'd)



- (8) China Southern Airlines Group Air Catering Company Limited (the "Catering Company"), a wholly owned subsidiary of CSAHC

The Company and the Catering Company entered into a catering agreement dated 12 November 2004 under which the Catering Company would supply (1) in-flight meals in accordance with the menus of in-flight meals to be agreed with the Company from time to time, and in such quantity as the Company shall advise the Catering Company in advance; and (2) catering services for different flights of the Company (including normal, additional, chartered and temporary flights) originating or stopping at the domestic airports, mainly in northern China and the Xinjiang regions where the Catering Company provides catering services.

The catering agreement is for a fixed term of three years, commencing from the date of the agreement. The parties have agreed, after arm's length negotiation, on the price of each type of in-flight meals and the service charges for each type of aircraft. The prices of in-flight meals and the service charges are not higher than the market rate of comparable in-flight meals and service charges. The Catering Company will issue an invoice listing out the quantity of in-flight meals supplied, the agreed unit price and the total price payable for each of the Company flight it provides service. The Cap for the Catering Agreement is set at RMB220,000,000 per year.

For the year ended 31 December 2005, the Company paid the in-flight meals charge of RMB112,136,000 pursuant to the catering agreement.

(C) Trademark Licence Agreement

The Company and CSAHC entered into a ten 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 the Company a renewable royalty free licence to use the kapok logo on a worldwide basis in connection with the Company's airline and airline-related businesses. Unless CSAHC gives a written notice of termination three months before the expiration of the agreement, the agreement will be automatically renewed for another ten-year term.

(D) Leases

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

- (a) The Company and CSAHC 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 RMB2,651,000 per year. The term of the lease is five years commencing 1 April 1997, renewable by both parties thereafter (subject to mutual agreement with respect to rental terms).
- (b) The Company and CSAHC 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 RMB15,745,000 per year. The term of each lease is one year, renewable by the parties thereafter (subject to mutual agreement with respect to rental terms).
- (c) The Company and CSAHC 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.

Report of the Directors (Cont'd)

- (d) The Company, CSAHC and CNA entered into a lease agreement dated 12 November 2004, under which CSAHC and CNA lease to the Company certain buildings, facilities and other infrastructure related to the civil aviation businesses of CNA situated at various locations in Shenyang, Dalian, Jilin, Harbin, Chaoyang and Russia. The lease is for a fixed term of three years, commencing from the date of the lease, and is renewable, subject to compliance with the relevant requirements of the Listing Rules by the Company, by an application in writing by the Company to the lessor three months before the end of the fixed term. The consideration for lease agreement is RMB43,758,000 per year, payable in arrear by cheque, in cash or by bank transfer on or before the 10th day of each calendar month, and is determined after arm's length negotiation between the parties. The Cap for the lease agreement is set at RMB43,758,000 per year. The lease agreement was approved by the shareholders of the Company at the 2nd extraordinary general meeting on 31 December 2004.
- (e) The Company, CSAHC and XJA entered into a lease agreement dated 12 November 2004, under which CSAHC and XJA lease to the Company certain buildings, facilities and other infrastructure related to the civil aviation businesses of XJA situated in Xinjiang and Russia. The lease is for a fixed term of three years, commencing from the effective date of the lease, and is renewable, subject to compliance with the relevant requirements of the Listing Rules by the Company, by an application in writing by the Company to the lessor three months before the end of the fixed term. The consideration for lease agreement is RMB5,798,000 per year, payable in arrear by cheque, in cash or by bank transfer on or before the 10th day of each calendar month, and is determined after arm's length negotiation between the parties. The Cap for the lease agreement is set at RMB5,798,000 per year. The lease agreement was approved by the shareholders of the Company at the 2nd extraordinary general meeting on 31 December 2004.
- (f) The Company and CSAHC entered into a lease agreement dated 12 November 2004, under which CSAHC leases to the Company certain lands by leasing the land use rights of such lands to the Company. These lands had been administratively allocated to Xinjiang Airlines and Northern Airlines for the purposes of their civil aviation and related businesses. Subsequently, CSAHC was authorised to deal with the land use rights of such lands, including leasing, but not transferring, such land use rights. Total area of the lands leased is 1,182,297 square metres, and the locations of such lands are in Urumqi, Shenyang, Dalian and Harbin. The lease is for a fixed term of three years, commencing from the effective date of the lease, and is renewable, subject to compliance with the relevant requirements of the Listing Rules by the Company, by an application in writing by the Company to the lessor three months before the end of the fixed term. The rent for the land use rights of the designed lands under lease agreement is RMB22,298,000 per year, payable in arrear by cheque, in cash or by bank transfer on or before the 10th day of each calendar month, and is determined after arm's length negotiation between the parties. The Cap for the lease agreement is set at RMB22,298,000 per year. The lease agreement was approved by the shareholders of the Company at the 2nd extraordinary general meeting on 31 December 2004.

The Independent Non-executive Directors of the Company have confirmed to the Board of the Company that they have reviewed the connected transactions described in (B) through (D) above (the "Connected Transactions") and have concluded that:

- (a) the Connected Transactions have been entered into by the Group in the ordinary and usual course of its business;

Report of the Directors (Cont'd)



- (b) the Connected 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 no less favourable to the Group than terms available to or from (as appropriate) independent third parties; and
- (c) the Connected Transactions have been performed in accordance with the terms of the relevant agreement governing each such Connected Transactions on terms that are fair and reasonable so far as the shareholders of the Company are concerned.

The auditors of the Company have carried out agreed upon procedures on the Connected Transactions and provided the Board with a letter stating that:

- (a) the Connected Transactions have been approved by the Board;
- (b) except for (d) below, they have carried out agreed upon procedures on selected samples of each of Connected Transactions, the samples were conducted in accordance with the terms of the relevant agreement;
- (c) except for (e) below, each of the Connected Transactions has not exceeded the Cap disclosed in the previous announcements;
- (d) certain lease agreements between the Company and CSAHC dated 22 May 1997 have expired, but the relevant continuing connected transactions thereunder still continued and rents payable were accrued according to the terms thereunder; and
- (e) as at 31 December 2005, no Cap was established for each of the following continuing connected transactions:
 - agreement with SAIETC for the import and export of aircraft, flight equipment, special vehicles for airline use, communication and navigation facilities and training facilities dated 22 May 1997;
 - agreement with SAAC for the provision of advertising services dated 22 May 1997;
 - agreement with Shenzhen Air Catering Company Limited for the sale and purchase of in-flight meals for flights originating or stopping at the airport in Shenzhen dated 23 May 1997;
 - agreement with Australian Pilot College for the provision of pilot training in Australia to the cadet pilots of CSAHC dated 7 October 1993;
 - agreement with Southern Airlines (Group) Economic Development Company for the provision of drinks, snacks, liquor, souvenirs and other products dated 22 May 1997; and
 - agreement with several Agents for the sale of the Group's air tickets.

Report of the Directors (Cont'd)

DONATIONS

During the year, the Group made donations for charitable purposes amounting to RMB45 million.

DESIGNATED DEPOSITS AND OVERDUE TIME DEPOSITS

As at 31 December 2005, 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.

LITIGATION

As stated in the 2004 annual report, the Company was involved as a defendant in a civil litigation (Hong Kong High Court Action No. 515 of 2001) ("Litigation"). According to the writ of summons for the Litigation, New Link Consultants Limited, the plaintiff, claimed against the Group (as one of the defendants to the Litigation) on the basis of certain evidence proving that United Aero-Supplies System of China, Limited ("UASSC") entered into an agreement with the defendants for exclusive purchase of aviation equipment consigned to UASSC for sale. As the defendants failed to perform the agreement, UASSC should have the right to compensation. Since UASSC was in the course of its winding up proceedings, all the rights and benefits of UASSC in connection with the claim were transferred to the plaintiff. The Company, as one of the defendants to the Litigation, was claimed for unspecified damages for breach of the agreement. The Company filed an objection in respect of the jurisdiction of the court, and requested the court to transfer the case to the PRC for trial. On 3 May 2004, the court made an award in favour of the Company for the transfer to the PRC, against which the plaintiff filed an appeal. In August 2005, the parties to the Litigation reached an out of court settlement, pursuant to which the plaintiff agreed to waive all its rights or possible rights to commence proceedings, claims or appeals against the Company in respect of the same matter.

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

Liu Shao Yong

Chairman

Guangzhou, the PRC

19 April 2006