

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 2006.

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 2006, 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 2006 in accordance with International Financial Reporting Standards ("IFRS") and PRC Accounting Rules and Regulations. See pages 42 to 194 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 2006 are set out on pages 198 and 199 of this Annual Report.

DIVIDENDS

No interim dividend was paid during the year ended 31 December 2006 (2005: Nil).

The Board of the Company does not recommend the payment of a final dividend in respect of the year ended 31 December 2006 (2005: 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 2006, RMB459 million (2005: RMB98 million) was capitalised as the cost of construction in progress and properties, plant and equipment under IFRS.

PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment of the Company and the Group and movements of property, plant and equipment during the year ended 31 December 2006 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 2006.

The percentage of purchases attributable to the Group's five largest suppliers in aggregate was less than 30% of the Group's total purchases (not including purchases of items which are of a capital nature) for the year ended 31 December 2006.

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 39 to the financial statements prepared under IFRS.

EMPLOYEES AND EMPLOYEES' PENSION SCHEME

As at 31 December 2006, the Group had an aggregate of 45,575 employees (2005: 41,167). Details of the employees' retirement and housing benefits are set out in notes 10 and 41 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 2006.

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 2006, to the knowledge of 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	2,200,000,000	-	68.75%	50.30%	-
HKSCC Nominees Limited	Direct holding	H Shares	1,151,319,998	98.05%	-	26.32%	-

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 2006:

- Among the 1,151,319,998 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).
- Among the 1,151,319,998 H Shares held by HKSCC Nominees Limited, J.P. Morgan Fleming Asset Management Holdings Inc. had an interest in an aggregate of 70,912,000 H Shares of the Company (representing approximately 6.04% 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, J.P. Morgan Fleming Asset Management Holdings Inc. held its interest in the Company in the following manners:
 - 70,162,000 H Shares, representing approximately 5.98% of the Company's then total issued H Shares, were held 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 J.P. Morgan Fleming Asset Management Holdings Inc.; and
 - 750,000 H Shares, representing approximately 0.06% of the Company's then total issued H Shares, were held by JF International Management Inc., which was approximately 99.99% held by J.P. Morgan Fleming Asset Management (Asia) Inc., which was ultimately 100% held by J.P. Morgan Fleming Asset Management Holdings Inc..
- Among the 1,151,319,998 H Shares held by HKSCC Nominees Limited, 70,658,800 H Shares, representing approximately 6.02% of the Company's then total issued H Shares, were held by JPMorgan Chase Bank, which was 100% held by J.P. Morgan Chase & Co.

Report of the Directors (Cont'd)

4. Among the 1,151,319,998 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) and maintained a short position of 616,000 H Shares of the Company (representing approximately 0.05% 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 in the manner as follows:
- (a) 743,322 H Shares, representing approximately 0.06% of the Company's then total issued H Shares, and a short position of 616,000 H Shares of the Company (representing approximately 0.05% of its 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.
5. Among the 1,151,319,998 H Shares held by HKSCC Nominees Limited, 96,938,500 H Shares, representing approximately 8.25% of the Company's then total issued H Shares, were held by Space Dragon Limited, which was 100% held by Cheung Kong Investment Company Limited.
6. Among the 1,151,319,998 H Shares held by HKSCC Nominees Limited, 96,938,500 H Shares, representing approximately 8.25% of the Company's then total issued H Shares, were held by Choicewell Limited, which was ultimately 100% held by Hutchison Whampoa Limited.
7. Among the 1,151,319,998 H Shares held by HKSCC Nominees Limited, Halbis Capital Management (Hong Kong) Limited had an interest in an aggregate of 73,764,000 H Shares of the Company (representing approximately 6.28% of its then total issued H Shares).

Save as disclosed above, as at 31 December 2006, 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 2006 was 92,828, of whom 90,941 were shareholders of A Shares and 1,887 were shareholders of H Shares.

Particulars of shareholdings of the Company's ten largest shareholders as at 31 December 2006 are as follows:

Shareholdings of ten largest shareholders

Name of shareholders	Nature of shareholders	Percentage (%)	Total number of shares	Pledged or frozen shares
CSAHC	State-owned shares holder	50.3	2,200,000,000	Unknown
HKSCC Nominees Limited	H shares holder	26.3	1,151,319,998	Unknown
State Social Security Fund 108 Combination	A shares holder	0.73	32,050,509	Unknown
The Industrial and Commercial Bank of China – Rongtong Motivation Pioneer Stock Securities Investment Fund	A shares holder	0.65	28,600,000	Unknown
Bank of China – Haifutong Dapan Jingxuan Securities Investment Fund	A shares holder	0.61	26,900,000	Unknown
State Social Security Fund 102 Combination	A shares holder	0.46	20,007,704	Unknown
International Finance – Standard Chartered – Citigroup Global Markets Limited	A shares holder	0.42	18,420,429	Unknown
China Construction Bank – Boshi Value Growth No. 2 Securities Investment Fund	A shares holder	0.39	16,862,323	Unknown
Boshi Value Growth Securities Investment Fund	A shares holder	0.35	15,139,000	Unknown
Tongqian Securities Investment Fund	A shares holder	0.31	13,590,000	Unknown

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 2006.

PRE-EMPTIVE RIGHTS

None of the Articles of Association of the Company provides for any pre-emptive rights requiring the Company to offer new shares to existing shareholders in proportion to their existing shareholdings.

Report of the Directors (Cont'd)

AUDIT COMMITTEE

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

THE MODEL CODE

Having made specific enquiries with all the Directors of the Company, the Directors have for the year ended 31 December 2006 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 2006.

DIRECTORS AND SUPERVISORS

Name	Position	Gender	Age
Liu Shao Yong	Chairman of the Board	Male	49
Li Wen Xin ⁽¹⁾	Director	Male	57
Wang Quan Hua	Director	Male	53
Zhao Liu An	Director	Male	59
Si Xian Min	Director, President	Male	50
Tan Wan Geng ⁽²⁾	Director, Vice President	Male	43
Xu Jie Bo	Director, Chief Financial officer and Vice President	Male	42
Chen Zhen You ⁽²⁾	Director	Male	55
Peter Lok	Independent Non-executive Director	Male	71
Wei Ming Hai	Independent Non-executive Director	Male	43
Wang Zhi	Independent Non-executive Director	Male	65
Sui Guang Jun	Independent Non-executive Director	Male	46
Sun Xiao Yi	Chairman of the Supervisory Committee	Male	53
Yang Guang Hua	Supervisor	Male	54
Yang Yi Hua	Supervisor	Female	47

(1) The appointment of Li Wen Xin as the director of the Company was approved at the first extraordinary general meeting 2006 of the Company held on 28 December 2006;

(2) The appointments of Tan Wan Geng and Chen Zhen You as the directors of the Company were approved at 2005 annual general meeting of the Company held on 15 June 2006;

(3) The retirement of Zhou Yong Qian as the director of the Company was approved at 2005 annual general meeting of the Company held on 15 June 2006.

Report of the Directors (Cont'd)

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

As at 31 December 2006, 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, Si Xian Min and Li Wen Xin which commenced on 29 November 2004, 31 December 2004 and 28 December 2006 respectively will expire at the end of the term for the current session of the Board; and the service contract of Tan Wan Geng and Chen Zhen You which commenced on 15 June 2006 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 2006, 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. Details of the connected transactions of the Company, as defined under the Listing Rules, conducted in 2006 which are required to be disclosed herein under the Listing Rules, are 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 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 and CSAHC (or Their Respective Subsidiaries)

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

The Company and SAIETC entered into an Import and Export Agency Framework Agreement dated 1 January 2006 for the import and export of aircraft, flight equipment, special vehicles for airline use, communication and navigation facilities, and training facilities.

The Import and Export Agency Framework Agreement is valid for a term of three years, commencing from the date of agreement, subject to compliance with the relevant provisions of the Listing Rules by the Company. Both parties agreed that the agency fee for import and export shall be determined after arm's length negotiation and shall not be higher than the market rate. The annual cap for such agreement shall be RMB80,000,000 per annum. The independent non-executive Directors of the Company have approved the Import and Export Agency Framework Agreement.

For the year ended 31 December 2006, the commission expense paid by the Group in respect of the import and export of the above equipment was RMB28,872,000.

- (2) *Southern Airlines Culture and Media Co., Ltd. ("SACM"), which is 50% owned by the Company and 50% owned by CSAHC*

The Company and Southern Airlines Advertising Company ("SAAC") entered into a new Advertising Agency Agreement dated 1 January 2006. SAAC and SACM entered into an acquisition agreement in 2006 whereby SACM acquired and merged with SAAC and assumed the rights, obligations and business of SAAC.

Advertising Agency Agreement is valid for a term of three years commencing from the date of the agreement. Under the agreement, SACM will produce advertisement script, graphic and music to the Company with the copyright of such products belonging to the Company, subject to compliance with the relevant provisions of the Listing Rules. 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 advertising services. The cap for the advertising agency fee shall be RMB30,000,000 for 2006. The independent non-executive Directors of the Company have approved such Advertising Agency Agreement.

For the year ended 31 December 2006, the amount incurred by the Group to SACM was RMB3,707,000.

Report of the Directors (Cont'd)

- (3) *China Southern Airlines Group Finance Company Limited ("SA Finance") which is 66% owned by CSAHC, 21% owned by the Company and 13% owned in aggregate by four subsidiaries of the Company*

The Company entered into a Financial Agreement ("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 was extended for six years to 22 May 2006. In order to comply with the new requirements under the Listing Rules, the Company was required to enter into separate agreement with SA Finance and comply with other provisions of the Listing Rules, so that SA Finance could continue to provide deposit of money service and other financial services to the Company. Therefore, the Company and SA Finance entered into a new Financial Agreement on 31 December 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 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 2006, the Group's deposits placed with SA Finance amounted to RMB629,366,000, which bore interest at the rate of 0.72% during the year.

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. In order to comply with the various requirements under the Listing Rules, the Company intends to enter into negotiation with Shenzhen Air Catering Company Limited to revise the agreement. The Company will comply with its obligations under the Listing Rules upon execution of the revised agreement.

For the year ended 31 December 2006, the amount incurred by the Group to Shenzhen Air Catering Company Limited for the provision of in-flight meals was approximately RMB56,204,000.

- (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. In order to comply with the various requirements under the Listing Rules, the Company intends to enter into negotiation with Australian Pilot College to revise the Training Agreement. The Company will comply with its obligations under the Listing Rules upon execution of the revised agreement.

For the year ended 31 December 2006, the amount paid by the Group to the Australian Pilot College for training services was RMB95,124,000.

- (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 2006, 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 RMB85,849,000.

- (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 3% to 6% 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.

Report of the Directors (Cont'd)

The Company and China Southern Airlines Group Passenger and Cargo Agent Company Limited ("PCAACL"), a wholly-owned subsidiary of CSAHC, have entered into a new ticket agency framework agreement and a new airfreight forwarding agency framework dated 1 January 2006 ("Two Sales Agency Framework Agreements").

The Two Sales Agency Framework Agreements are valid for a term of three years commencing from the date of the agreements, subject to the compliance of relevant provisions under the Listing Rules. The parties agreed that the agency fee shall be determined after arm's length negotiation and shall not be higher than the market rate. The annual cap under each of the Two Sales Agency Framework Agreements is set at RMB10,000,000 per annum. The independent non-executive Directors of the Company have approved these Two Sales Agency Framework Agreement.

For the year ended 31 December 2006, the aggregate amount of ticket sales of the Company conducted through the Agents was RMB701,441,000.

- (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 ("Catering Agreement") 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 2006, the Company paid the in-flight meals charge of RMB138,084,000 pursuant to the Catering Agreement.

- (9) *China Southern Airlines Group Travel Development Company Limited ("CSA Travel"), a wholly owned subsidiary of CSAHC*

The Company and CSA Travel entered into a Framework Agreement on Lease, Operation and Management ("Framework Agreement on Lease and Operation") dated 1 January 2006 regarding hotel leasing and providing relevant service for a fixed term of three years. According to this agreement, the Company will lease certain hotels or certain divisions of these hotels belonging to it to CSA Travel for it to operate, and to provide certain relevant services and the Company is entitled to employ CSA Travel to provide property cleaning or ticket agent service according to business development, which is subject to separate agreement according to the Framework Agreement on Lease and Operation. The relevant fee was determined on an arm's length between both parties and the price shall not be higher than the market rate. The annual cap for the Framework Agreement on Lease and Operation is set at RMB6,000,000 per annum. The Framework Agreement on Lease and Operation has been approved by the independent non-executive Directors of the Company.

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- (10) *Guangzhou China Southern Airlines Property Management Company Limited (the "GCSAPMC"), which is 90% owned by CSAHC and 10% owned by the Company's Union*

The Company and GCSAPMC entered into a Framework Agreement for the Engagement of Property Management ("Property Management Framework Agreement") dated 1 January 2006 in respect of engaging GCSAPMC to provide property management and improvement service with a term of three years from the date of this agreement. Pursuant to the agreement, the Company has appointed GCSAPMC to provide management and maintenance services for the Company's headquarters in Guangzhou and to provide maintenance and management services for the 110KV transformer substation to ensure the ideal working conditions of the Company's production and office facilities and physical environment, and the normal operation of equipment. The fee charging schedule (or charge standard) shall be determined at an arm's length between both parties, and will not be higher than the one of independent third parties in the similar industry. The annual cap for the Property Management Framework Agreement Framework Agreement is set at RMB47,010,000 per annum. The Property Management Framework Agreement has been approved by the independent non-executive Directors of the Company.

For the year ended 31 December 2006, the Company paid the property management and maintenance fee of RMB26,402,000 pursuant to the Property Management Framework 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 and 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

In order to comply with the various requirements under Listing Rules in respect of connected transactions of the Company, the Company and CSAHC, the controlling shareholder of the Company, have revised or renewed the following connected transactions of the Company in relation to the leases of certain parcels of land, properties and office premises:

- (1) On 22 May 1997, the Company and CSAHC entered into a Lease Agreement pursuant to which CSAHC leased to the Company certain land and properties at various locations in Guangzhou, Haikou and Wuhan for a term of five years, which was renewable by agreement between both parties thereto. (Please see 2003 Prospectus of Public Offering of A Shares of the Company.)

On 15 May 2001, the Company and CSAHC entered into a Lease Agreement pursuant to which CSAHC leased to the Company certain parcels of land, properties, and buildings at various locations at Hengyang, Jingzhou (previously known as "Shashi") and Nanyang for a term of five years, and the rents were calculated on the basis of annual depreciation method. Such Lease Agreement was renewable by agreement between both parties thereto.

In order to comply with the relevant provisions of the Listing Rules regarding connected transactions, the Company and the Group have entered into a general lease agreement based on the above agreements through determination and negotiation regarding the actual situation of the lands, properties and buildings located in above areas. This Lease Agreement takes effect retrospectively on 1 January 2006, and is valid for a term of three years. Under this Lease Agreement, the total rent payable is RMB86,029,619.01, of which, the annual rents payable for the year 2006, 2007 and 2008 are RMB27,543,606.01, RMB28,657,966.99 and RMB29,828,046.01 respectively. However, the total rents in the original several lease agreements are RMB92,452,479.48 for the term of five years.

Report of the Directors (Cont'd)

- (2) 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.
- (3) The Company, CSAHC and China Northern Airlines ("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 second extraordinary general meeting on 31 December 2004.
- (4) The Company, CSAHC and Xinjiang Airlines ("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 second extraordinary general meeting on 31 December 2004.
- (5) 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 XJA and CNA 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 designated 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 second extraordinary general meeting on 31 December 2004.

Report of the Directors (Cont'd)

(E) Sale of properties

The Company and CSAHC entered into the properties sale agreement (the "Properties Sale Agreement"), dated on 28 December 2006 (after trading hours), according to which, the Company will sell to CSAHC the Properties with total area of 12,008.09 square meters including the 757 aircraft supplies depot, 737 aircraft supplies depot, 777 aircraft supplies depot, Building no. 143 aircraft supplies depot, Building No. 144 aircraft supplies depot and a new engine depot located within the vicinity of old Guangzhou Baiyun Airport (the "Properties").

The consideration payable under the Properties Sale Agreement is RMB23,347,170.60. The net book value of the Properties is RMB19,886,352.67 as of 30 June 2006. The consideration has been determined after arm's length negotiations by the Company and CSAHC, with consideration given also to the existing conditions of the Properties and relevant Assets Valuation Report. The Properties, situated at the old Guangzhou Baiyun Airport, are not used by the Company since the moving of the Company's business and operations to the new Guangzhou Baiyun Airport. The Properties are part of the assets transferred by CSAHC to the Company pursuant to De-merger Agreement dated 25 March 1995 (as amended by Amendment No. 1 dated 22 May 1997 (the "De-merger Agreement"). Under the De-merger Agreement, CSAHC has agreed to indemnify the Company against claims, liabilities and expenses incurred by it relating to the business, assets held or assumed by the Company pursuant to the De-merger Agreement, including the Properties.

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 (E) 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;
- (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 carried out 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 (the "Letter") stating that:

- (a) the Connected Transactions have been approved by the Board;
- (b) except for (c) below, they have carried out agreed upon procedures on selected samples of each of Connected Transactions, and confirmed the transactions selected were carried out in accordance with the terms of the relevant agreement;
- (c) the Company and CSA Travel entered into a Framework Agreement on Lease and Operation on 1 January 2006 regarding leasing of certain hotel and buildings. Based on that agreement, the annual cap is set at RMB6,000,000 per annum. As of the date of this Annual Report, the Company and CSA Travel are still in negotiation over the terms and conditions of the lease and rent. As a result, the auditors could not carry out the agreed upon procedures as to whether the related transactions have been carried out in accordance with the provisions thereunder;

Report of the Directors (Cont'd)

- (d) except for (e) below, each of the Connected Transactions has not exceeded the Cap disclosed in the previous announcements; and
- (e) as at 31 December 2006, no cap was established for each of the following continuing connected transactions:
- agreement dated 23 May 1997 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;
 - agreement dated 7 October 1993 with Australian Pilot College for the provision of pilot training in Australia to the cadet pilots of CSAHC; and
 - agreement dated 22 May 1997 with Southern Airlines (Group) Economic Development Company for the provision of drinks, snacks, liquor, souvenirs and other products.

DONATIONS

During the year, the Group made donations for charitable purposes amounting to RMB6 million.

DESIGNATED DEPOSITS AND OVERDUE TIME DEPOSITS

As at 31 December 2006, 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

During the year ended 31 December 2006, the Company was not involved in any material litigations.

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

16 April 2007