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## REGULATION

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### THE INTERNATIONAL REGULATORY FRAMEWORK

International commercial air transport is regulated by international conventions that each participating country undertakes to ratify and directly apply within its national air space. The principal international conventions are the Convention for the Unification of Certain Rules Relating to International Carriage by Air of 1929 (the “Warsaw Convention”), the Convention on International Civil Aviation of 1944 (the “Chicago Convention”), and the Convention for the Unification of Certain Rules for International Carriage by Air of 1999 (the “Montreal Convention”).

#### *The Warsaw Convention and the Hague Protocol, and the Montreal Convention*

The Warsaw Convention, which was later modified by the Protocol to Amend the Convention for the Unification of Certain Rules Relating to International Carriage by Air of 1929 (the “Hague Protocol”), established the principle of limited liability of air transport companies based on a presumption of fault. The financial limits on liability set out in the Warsaw Convention may be exceeded only if it is proved that the damage resulted from an act or omission of the carrier done (1) with intent to cause damage or (2) recklessly and with knowledge that damage would probably result. China is a party to the Warsaw Convention.

The Montreal Convention changed the airline accident liability system established by the Warsaw Convention. It changed the low liability limits and modernised and clarified other aspects of the international airline accident liability system. China is currently not a party to the Montreal Convention.

#### *The Chicago Convention*

The Chicago Convention sets out the legal and technical principles governing international commercial aviation. In addition, the Chicago Convention subjects participant states, which include substantially all the member states of the United Nations, to a common legal framework governing international air transport that participant states are required to implement in their respective national air space and apply in their relations with each another. The Chicago Convention established the general principle that each state has sovereignty over its air space and has the right to control the operation of scheduled international air services over or into its territory.

The Chicago Convention permits non-scheduled flights, both charter and cargo, to fly over the territories of participant states and gives rights for non-scheduled flights to make stops for non-traffic purposes in the territories of such states, subject to certain restrictions which may be imposed by the individual states. China is a party to the Chicago Convention.

The International Civil Aviation Organisation (“ICAO”) was established based on the Chicago Convention and in 1947 became the aviation division of the United Nations. Within the framework of the ICAO, participant states establish the international technical regulations applicable to civil aviation.

#### *International Air Transportation Association*

The International Air Transportation Association (“IATA”) provides an important international self-regulatory framework for the airline industry. Established in 1945, IATA has approximately 270 members, including almost every major airline in the world, and its members

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generate more than 98% of all international scheduled air traffic. The main functions of IATA include:

- establishing regulations for certain aspects of the airline industry;
- setting tariff for international passenger and cargo services;
- settling payments among IATA members or between IATA members and non-members;
- licensing of travel agents;
- improving technological co-operation among IATA members; and
- improving the performance and efficiency of airports.

We have been a member of IATA since 1993.

Under the auspices of IATA, airlines have entered into agreements that have modified the limits of liability for injured or deceased passengers established by the Warsaw Convention. Pursuant to the IATA Inter-carrier Agreement on Passenger Liability, signatory airlines agreed to waive the limitation of liability on recoverable compensatory damages under the Warsaw Convention to enable recoverable compensatory damages to be determined and awarded by reference to the law of the domicile of the passenger. Many IATA members have also entered into the Agreement on Measures to Implement the IATA Inter-carrier Agreement pursuant to which signatory airlines have agreed that injured passengers or dependants of deceased passengers can receive up to 100,000 Special Drawing Rights (“SDR”). SDR is an artificial currency unit created by the International Monetary Fund and 100,000 SDR represents an equivalent of approximately US\$146,600 as of June 30, 2004.

We have been a party to both the IATA Inter-carrier Agreement on Passenger Liability and the Agreement on Measures to Implement the IATA Inter-carrier Agreement since 1998.

### *Allocation of Slots*

Access to many of the world’s major international airports is regulated by the allotment of time slots. Slots correspond to the ability of an airline to land at, or take-off from, an airport at a specified time and date. Access to most European and Asian airports is regulated through slots. In the United States, access to airports is controlled by regulations based on the allotment of boarding gates with the exception of New York’s John F. Kennedy airport and Chicago’s O’Hare airport, to which access is regulated by slots. As a general rule, a slot that has been operated by an airline entitles that airline to claim the same slot in the next equivalent scheduling period (often referred to as “grandfather rights”).

### *Bilateral Air Services Agreements*

International air transport requires transport rights (a concept known as “traffic rights” or “route rights”) which one state may acquire by applying for another state’s transport rights by entering into bilateral air transport agreements, also frequently referred to as air services agreements. Bilateral air services agreements between states generally contain the principles governing the designation of airlines for the operation of specified routes, the capacity offered by such airlines and the procedures for the agreement of tariffs. Contracting states under bilateral air services agreements typically designate only one or a small number of national airlines to exercise

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the rights to operate on the routes granted to its parent state by other states under bilateral air services agreements or treaties. China is a party to 93 bilateral air services agreements.

### REGULATION OF THE CHINESE AIRLINE INDUSTRY

#### *The PRC Civil Aviation Law*

The airline industry in China is regulated under the PRC Civil Aviation Law. The Civil Aviation Law, which became effective in March 1996, provides the framework for regulating many aspects of commercial aviation in China, including:

- the administration of airports and air traffic control systems;
- aircraft registration and aircraft airworthiness certification;
- operational safety standards; and
- the liabilities of carriers.

#### *CAAC*

All airlines engaged in air transportation in China are subject to a high degree of regulation and supervision by the CAAC. The CAAC is a ministry under the supervision of the State Council responsible for national commercial aviation affairs, including the following:

- establishment of policies and long-term plans for the civil aviation industry;
- promulgation of rules, regulations and operational standards for commercial aviation and supervision of the implementation of the laws, rules, regulations and standards;
- supervision of the restructuring and consolidation of the airline industry;
- determination of airfare policies for domestic routes (in consultation with the pricing department of the NDRC);
- allocation of domestic, Hong Kong and Macau and international route rights;
- administration of the operational licences for airlines and commercial airports;
- ensuring flight safety, airworthiness and aviation security;
- investigation of accidents;
- co-ordination of aircraft and aircraft equipment procurement;
- administration and operation of the China Aviation Flight University of China;
- representation of the PRC government in negotiations with foreign governments on bilateral air services agreements; and
- representation of the PRC government in international civil aviation organisations and intergovernmental activities.

#### *Airfare Pricing*

##### *International Airfare*

Published airfares for international routes are determined through consultation between the relevant Chinese airlines and international airlines in accordance with the air services agreements

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between the PRC government and the relevant foreign governments, with consideration given to the international airfare standards established through the IATA. All published airfares for international routes must be approved by the CAAC.

### *Domestic Airfare*

Under the PRC Civil Aviation Law, airfare policies for domestic routes are determined jointly by the NDRC and the CAAC. From February 1999 to March 2001, all Chinese airlines were required to adhere to unified domestic airfares published by the CAAC from time to time and discounted sales were prohibited, although in practice many Chinese airlines often offered discounts based on market demands. In 2001, the CAAC began relaxing its control over domestic airfare pricing and permitted Chinese airlines to offer discounts on several major domestic routes.

On March 17, 2004, the NDRC and the CAAC announced a new policy for domestic airfares, which became effective on April 20, 2004. Under the new policy, the PRC government no longer directly sets domestic airfares but instead sets the benchmark airfares and allows actual airfares to fluctuate within a certain price range. Prices for benchmark airfares are based on several factors, including average operating costs, supply and market demand and the ability of customers to pay. The NDRC and the CAAC jointly publish from time to time the benchmark airfares and permitted ranges in which actual airfares may fluctuate. Pursuant to current pricing guidelines, benchmark airfares are based on the average airfare of RMB0.75 per passenger-kilometre.

The actual airfares for most of the domestic routes published or charged by each Chinese airline cannot be 25% higher or 45% lower than the basic benchmark airfares. However, intra-province and certain adjacent province-to-province routes are not subject to the range restrictions, and certain tourist routes and routes served by only one Chinese airline are not subject to the bottom range restriction. Chinese airlines may apply to the NDRC and the CAAC for exemption from the bottom range restriction for a particular route.

Chinese airlines are required to file the actual airfares they set for their domestic routes within the range limitations through Travelsky's reservation system 30 days prior to the date that the airfares become effective. Under the new rule, the NDRC and the CAAC regularly review the average operating costs of Chinese airlines, and may adjust the basic benchmark airfare for particular domestic routes if they believe the actual airfares are not reasonable.

### *Hong Kong and Macau Airfare*

Published airfares of mainland airlines for the Hong Kong and Macau routes are determined by the CAAC and the relevant civil aviation authorities in Hong Kong or Macau, subject to consultation between the relevant mainland airlines and Hong Kong or Macau airlines. Mainland airlines are permitted to offer discounts on flights on their Hong Kong or Macau routes.

## ***Route Rights***

### *International Routes*

International route rights are generally based on air services agreements negotiated by the PRC government, through the CAAC, and the governments of the relevant countries. Under these agreements, each government grants to the other the right to designate an airline or airlines of the relevant country to operate scheduled services on the specified routes. Each airline designated to fly the international route must also obtain the necessary operating permits from the relevant

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foreign government. Such operating permits are unlikely to be withheld so long as the airline fulfils the conditions prescribed under the laws and regulations normally and reasonably applied to the operation of international air services by the relevant aviation authority of the foreign government, including meeting the required international safety standards.

Once an air services agreement has been reached, the CAAC awards the international route rights to certain Chinese airlines qualified to fly international routes based on certain criteria, including quality of the services, availability of appropriate aircraft and aircraft equipment, management and flight personnel, management system, size of the airline, safety record, financial condition, on-time performance, hub location and ability to bear civil liabilities in international air services. The CAAC can terminate international route rights awarded to Chinese airlines under special circumstances. However, Chinese airlines cannot terminate service on any particular international route without the CAAC's approval.

If more than one Chinese airline are permitted under the relevant bilateral air services agreement to operate a particular international route, the CAAC may determine to allocate the international route to specific airlines. This decision is based on a number of factors, including overall national policy objectives, advancement of orderly competition, the availability of international airports that can support an appropriate level of maintenance standards and safety measures consistent with international practices.

### *Domestic Routes*

Under current CAAC rules and regulations, foreign airlines are not permitted to provide domestic passenger or cargo services between destinations in China. Chinese airlines must obtain the route right to carry passengers or cargo on any domestic route from the CAAC. To qualify for the grant of route rights, Chinese airlines must meet the following minimum qualifications:

- compliance with its business scope specified in enterprise business licence;
- compliance with pricing regulations;
- on-time performance and quality of service;
- compliance with market demand; and
- ability to operate on the particular route, including availability of aircraft, flight personnel, airport facilities and other related support services.

When allocating domestic route rights where more than one airline are competing for a particular route, the CAAC balances a number of factors in determining which airline is better suited to serve the route. The location of the airline's main or regional base is an important factor. Under current CAAC policy, Chinese airlines are generally granted the rights to operate mainly from their principal bases, and flights within a particular region are expected to be served by airlines based in that region.

Market demand is also an important factor in the CAAC's decision of whether to grant more flights on a particular route to the incumbent Chinese airline and whether to allocate an existing route right to an additional Chinese airline. Priority is given to airlines currently serving the route for additional flights, and only when such airlines cannot operate more flights will the CAAC grant the route right to another airline. CAAC approval is required before additional flights may be added to any particular route.

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Approval from the CAAC is required for flight plans. Flight plans are published twice a year, one each for the summer schedule and winter schedule. All Chinese airlines are required to submit their flight schedules to the CAAC for approval 120 days before the schedule is implemented.

### *Hong Kong and Macau Routes*

Hong Kong route rights and the corresponding landing rights are based on air transportation arrangements entered into between the PRC government and the government of the Hong Kong Special Administrative Region. The air transportation arrangements provide for equal opportunities for airlines based in Hong Kong and airlines of the mainland of China. The CAAC awards the Hong Kong route rights to the mainland airlines designated to operate flights to and from Hong Kong based on the same criteria as those applicable to international routes.

Macau route rights and the corresponding landing rights are based on the air transportation arrangements entered into between the PRC government and the government of the Macau Special Administrative Region. According to the arrangements, designated mainland and Macau airlines may provide scheduled combination passenger and cargo services and dedicated cargo services on the routes between Macau and specified cities in the mainland of China. The arrangements specify the frequencies of operation for the designated airline on each side and allow designated airlines on both sides to engage in various kinds of co-operation, including codeshare arrangements.

For more information regarding the recently amended air services arrangements between the PRC government and the governments of the Hong Kong and Macau Special Administrative Regions, see the section headed “Industry Overview — Deregulation of the Chinese Airline Industry — Traffic Rights.”

### *Airport Policy*

Prior to September 2003, all commercial airports in China were owned by the CAAC or by provincial or municipal governments. In September 2003, as part of the restructuring of the airline industry in China, the CAAC transferred the management and operation of 90 civilian airports to provincial or municipal governments. However, the CAAC still retains the right to operate Beijing Capital International Airport, Tianjin Binhai International Airport and the airports in Tibet. The CAAC has the authority to determine the take-off and landing charges, as well as charges on airlines for the use of other airport facilities. Beginning September 1, 2004, the airport construction fee, which was previously charged apart from the ticket, has been included in the price of the ticket.

### *CAAC Infrastructure Development Fund*

Historically, the PRC government has required all Chinese airlines to contribute to the CAAC Infrastructure Development Fund to help finance the cost of improving China’s commercial aviation facilities. Each Chinese airline’s contribution to the fund was based on specified percentages of domestic and international air service revenues. After the outbreak of SARS in 2003, the PRC government temporarily suspended its requirement for contributions to the CAAC Infrastructure Development Fund. According to a new rule promulgated by the Ministry of Finance of China, which became effective on April 1, 2004, contribution to the CAAC Infrastructure Development Fund is to be charged based on usage of domestic routes and the domestic segments of international routes. The amount is determined based on the geographic area and length of the routes and aircraft weight.

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### *Aircraft and Aircraft Equipment Procurement*

The NDRC and the CAAC's approvals are required prior to any acquisition by Chinese airlines of aircraft. Aircraft operating leases within a year only need CAAC approval. Unlike aircraft, the purchase of aircraft equipment (including aircraft engines, spare parts and other aviation equipment) is not subject to government approvals in China. However, since most Chinese airlines are not permitted under PRC law to import or export aircraft equipment, they typically purchase such materials through the CASGC. The CASGC receives a commission in connection with every purchase of aircraft or aircraft equipment. Aircraft and aircraft equipment procurement plans are initiated by individual airlines and the CASGC does not determine each airline's procurement plans. Chinese airlines typically enter into group framework agreements through the CASGC to take advantage of more favourable terms and conditions of group procurement. After the group framework agreement has been signed by the CASGC, each Chinese airline will negotiate purchase orders directly with vendors.

### *Tax on Import of Aircraft*

The import of aircraft in China is subject to a value-added tax regulated by the Ministry of Finance and the State Taxation Administration of the PRC. Effective from October 1, 2004, the value-added tax rate for the import of passenger aircraft and freighters (with load capacity above 25 tonnes) by Chinese airlines was reduced from the previous tax rate of 6% to 4%.

### *Jet Fuel*

The import of jet fuel is regulated in China, and only government-approved entities can import jet fuel to China. Due to historical reasons, CAOHC is currently the dominant jet fuel supplier in China. Historically, domestic jet fuel price, which was determined by the State Development Planning Commission, was not directly linked to the international jet fuel market. Since 2000, the NDRC, the successor entity to the State Development Planning Commission, has published a benchmark jet fuel price every one or two months based on the average Singapore jet fuel price of the previous month published by Platts. The NDRC price also includes customs tax and value-added tax imposed by the PRC government. The CAAC, which is authorised to determine the domestic retail price of jet fuel, adjusts the retail price of jet fuel based on the costs of transportation, market conditions and other factors.

### *Safety*

In general, ICAO establishes safety standards for the airline industry. The civil aviation administration authority of the country in which the airline is incorporated implements related regulations and is responsible for ensuring that the aircraft and flight crew meet such standards. All members of ICAO recognise certifications of compliance issued by the country of registry.

The CAAC has jurisdiction over operational safety, maintenance and training standards for all Chinese airlines. The CAAC also issues rules and regulations relating to, among other things, aircraft maintenance and operations, equipment, dispatch, communications, flight personnel and other matters affecting air safety. The CAAC requires each Chinese airline to provide flight safety records to the CAAC periodically, including the reports of flight incidents or accidents involving its aircraft during the relevant reporting period and other safety-related problems. To ensure compliance with its regulations, the CAAC conducts periodic safety inspections on each Chinese airline. Failure to meet the safety standards may result in fines or other administrative penalties.

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All aircraft operated by Chinese airlines, other than a limited number of leased aircraft registered in foreign countries, are required to be registered with the CAAC. In addition, all providers of MRO services, including airlines, are required to obtain a maintenance certification in order to perform maintenance work on aircraft. The CAAC issues maintenance certification to a Chinese airline only after its maintenance capabilities have been examined and assessed by the CAAC. All aircraft operated by Chinese airlines must also be maintained and repaired at CAAC-certified maintenance facilities, whether in China or abroad.

The CAAC establishes the training standards of all Chinese airline pilots and implements a uniform pilot certification process. Every pilot employed by a Chinese airline must pass CAAC-administered examinations before obtaining a pilot's licence and must be recertified every year.

### *Security*

The CAAC establishes and oversees the implementation of security standards and regulations based on the PRC laws and standards established by ICAO. The CAAC requires each Chinese airline and airport to submit to the CAAC an aviation security handbook describing specific security procedures established by the airline or airport for the day-to-day operations and security training for staff of such airline or airport. Such procedures must be adopted in accordance with CAAC regulations. Chinese airlines that operate international routes, and Chinese airports that serve as the origination point of international flights, must also adopt security measures in accordance with the requirements of the relevant international agreements.

### *Airworthiness*

The CAAC is responsible for the regulation and supervision of the airworthiness of all commercial aircraft registered in China. An aircraft can be operated only when an airworthiness certificate has been issued to the relevant aircraft. An airworthiness certificate specifies, among other things, the approved type of activities of the aircraft, the period of validity of the certificate and other conditions and restrictions required to ensure the safe operation of the aircraft. A non-Chinese registered aircraft leased by a Chinese entity may be operated in China only after the CAAC has examined and approved the airworthiness certificate issued by the country of registry of the relevant aircraft or only after the CAAC has issued a new airworthiness certificate to the aircraft.

### *Environmental and Noise Regulation*

All airlines and airports in China are required to comply with the environmental and noise regulations of the PRC government. These regulations include rules relating to discharges to surface and subsurface waters, the management of hazardous substances, oils and waste materials and levels of noise. Under the regulations of the CAAC, Chinese airports can deny take-off and landing rights to any aircraft not in compliance with the noise regulations. Chinese airlines are also subject to the environmental and noise regulations in each country that they operate in.

### *Foreign Ownership Restrictions*

Under the current policies of the CAAC, ownership of a Chinese airline by non-PRC persons and Hong Kong, Macau or Taiwan persons in the aggregate must be less than 50% of the airline's issued share capital. In addition, no single non-PRC investor (including its affiliates) is permitted to own more than 25% of the issued share capital of a Chinese airline. Airlines are not required



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under PRC law to have internal procedures to ensure such airline is in compliance with the foreign ownership restrictions.

### *Compensation to Passengers for Delayed Flights*

In June 2004, the CAAC issued “Guidance for Domestic Airlines’ Compensation to Passengers for Delayed Flights Caused by Factors Within the Airlines’ Control (For Trial Implementation),” which became effective on July 1, 2004. The new guidelines encourage Chinese airlines to compensate passengers of delayed flights but do not specifically address when airlines must comply with the new guidelines and whether any fines or penalties would be imposed on airlines for failure to comply. The CAAC indicated in the new guidelines that it may adopt and implement more concrete measures at a later date. As of the date of this Prospectus, the CAAC has not promulgated such measures.