



Report of the Directors

The Board of Directors of the Company hereby presents this Annual Report and the audited financial statements for the year ended 31 December, 2004.

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 2004, the Group ranked first among all Chinese airlines in terms of passenger traffic volume, number of scheduled flights per week, number of hours flown, number of routes and size of aircraft fleet. The Group has prepared the results of operations for the year ended 31 December, 2004 and the financial position of the Company and the Group as of that date in accordance with IFRS and PRC Accounting Rules and Regulations. See pages 43 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, 2004 are set out on pages 185 and 186 of this Annual Report.

DIVIDENDS

No interim dividend was paid during the year ended 31 December, 2004 (2003: Nil).

The Board of Directors of the Company does not recommend the payment of a final dividend in respect of the year ended 31 December, 2004 (2003: 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 21 and 22 to the financial statements prepared under IFRS.

INTEREST CAPITALISATION

For the year ended 31 December, 2004, RMB34 million (2003: RMB83 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, 2004 are set out in note 10 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, 2004.

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, 2004.

Report of the Directors (Cont'd)

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.

TAXATION

Details of taxation of the Company and the Group are set out in note 7 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 27 to the financial statements prepared under IFRS.

EMPLOYEES AND EMPLOYEES' PENSION SCHEME

As at 31 December, 2004, the Group had an aggregate of 18,221 employees (2003: 17,569). Details of the employees' pension schemes and other welfare are set out in note 29 to the financial statements prepared under IFRS.

SUBSIDIARIES

Details of the principal subsidiaries of the Company are set out in note 37 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, 2004.

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 shares	50.30
2. Listed shares		
(a) Overseas listed foreign shares (H Shares)	1,174,178,000 shares	26.84
(b) Domestic listed ordinary shares (A Shares)	1,000,000,000 shares	22.86
Total share capital	4,374,178,000 shares	100.00



Report of the Directors (Cont'd)

SUBSTANTIAL SHAREHOLDERS

As at 31 December, 2004 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	1,151,953,998	98.11%	-	26.34%	-

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, 2004:

1. Among the 1,151,953,998 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 1,151,953,998 H Shares held by HKSCC Nominees Limited, JPMorgan Chase & Co. had an interest in an aggregate of 95,788,800 H Shares of the Company (representing approximately 8.16% of its then total issued H Shares). Out of the 95,788,800 H Shares, JPMorgan Chase & Co. had an interest in a lending pool comprising 8,038,000 H Shares of the Company (representing approximately 0.68% 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) 8,038,000 H Shares in a lending pool, representing approximately 0.68% 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) 1,064,800 H Shares, representing approximately 0.09% 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.;
 - (c) 84,536,000 H Shares, representing approximately 7.20% 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.; and

Report of the Directors (Cont'd)

- (d) 2,150,000 H Shares, representing approximately 0.18% of the Company's then total issued H Shares, were held in the capacity as beneficial owner by JF International Management Inc., which was ultimately 100% held by JPMorgan Chase & Co..
3. Among the 1,151,953,998 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, 2004 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, 2004, 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 1,151,953,998 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 1,151,953,998 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, 2004, 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, 2004 was 115,847, of which 113,618 were shareholders of A Shares and 2,229 were shareholders of H Shares.

Particulars of shareholdings of the Company's ten largest shareholders as at the end of the reporting period are as follows:

Shareholdings of the ten largest shareholders

No.	Name of shareholders	Movement during the year (share)	Shareholdings at the end of the year (share)	Percentage %	Type of shares	Pledged or frozen shares	Nature of shares held
1.	CSAHC	0	2,200,000,000	50.30	Unlisted	Unknown	State-owned shares
2.	HKSCC NOMINEES LIMITED	1,998,000	1,151,953,998	26.34	Listed	Unknown	H Shares
3.	Bank of China – Huaxia Return Securities Investment Fund	(21,126,482)	35,739,259	0.82	Listed	Unknown	A Shares
4.	Huaxia Growth Securities Investment Fund	(28,447,027)	30,552,973	0.70	Listed	Unknown	A Shares
5.	China Merchant Bank Co., Ltd. – Zhong Xin Jing Dian Pei Zhi Securities Investment Fund	30,530,870	30,530,879	0.70	Listed	Unknown	A Shares
6.	The Industrial and Commercial Bank of China – Galaxy Yin Tai Li Cai Fen Hong Securities Investment Fund	24,291,931	24,291,931	0.56	Listed	Unknown	A Shares
7.	Bank of China – Jiashi Service Value-added Industry Securities Investment Fund	23,861,475	23,861,475	0.55	Listed	Unknown	A Shares
8.	Yinfeng Securities Investment Fund	(2,386,412)	23,310,956	0.53	Listed	Unknown	A Shares
9.	Bank of Communications – Yi Fang Da 50 Index Securities Investment Fund	22,024,754	22,024,754	0.50	Listed	Unknown	A Shares
10.	Xinghua Securities Investment Fund	(10,284,269)	19,875,921	0.45	Listed	Unknown	A Shares

Report of the Directors (Cont'd)

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, 2004.

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.

THE MODEL CODE

Having made specific enquiries with all the Directors of the Company, the Directors have for the year ended 31 December, 2004 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 Hong Kong Stock Exchange (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 OF BEST PRACTICE

In the opinion of the Directors of the Company, the Group has complied with the Code of Best Practice set out in Appendix 14 of the Listing Rules issued by the Hong Kong Stock Exchange throughout the year ended 31 December, 2004.



Report of the Directors (Cont'd)

DIRECTORS, SUPERVISORS AND SENIOR ADMINISTRATIVE OFFICERS

Directors, Supervisors and senior administrative officers of the Company in 2004 were as follows:

Name	Position	Gender	Age
Liu Shao Yong	Chairman of the Board of Directors	Male	46
Liu Ming Qi	Vice Chairman of the Board of Directors	Male	61
Peng An Fa	Director	Male	57
Wang Quan Hua	Director	Male	51
Zhao Liu An	Director	Male	57
Zhou Yong Qian	Director	Male	60
Si Xian Min	Director, President	Male	47
Zhou Yong Jin	Director	Male	62
Xu Jie Bo	Director, Chief Financial Officer, Vice President	Male	40
Wu Rong Nan	Director	Male	63
Simon To	Independent Non-executive Director	Male	54
Peter Lok	Independent Non-executive Director	Male	69
Wei Ming Hai	Independent Non-executive Director	Male	41
Wang Zhi	Independent Non-executive Director	Male	63
Sui Guang Jun	Independent Non-executive Director	Male	44
Sun Xiao Yi	Chairman of the Supervisory Committee	Male	51
Yang Guang Hua	Supervisor	Male	52
Yang Yi Hua	Supervisor	Female	45
Li Kun	Vice President	Male	45
Yuan Xin An	Vice President, Chief Engineer	Male	48
Zheng En Ren	Vice President	Male	60
Hao Jian Hua	Vice President	Male	55
Ren Ji Dong	Vice President	Male	40
He Zong Kai	Vice President	Male	53
Liu Qian	Chief Pilot	Male	40
Su Liang	Company Secretary	Male	43
Chen Wei Hua	General Counsel	Male	38

On 16 June, 2004, the appointment of Sun Xiao Yi, Yang Guang Hua and Yang Yi Hua as Supervisors, and the resignation of Liang Hua Fu, Gan Yu Hua and Li Qi Hong as Supervisors were approved at the annual general meeting of the shareholders of the Company. On the same date, the Supervisory Committee of the Company elected Sun Xiao Yi as the chairman of the Supervisory Committee of the Company.

On 8 October, 2004, the resignation of Yan Zhi Qing as the chairman of the Board of Directors of the Company was approved by the Board of Directors.

Report of the Directors (Cont'd)

On 28 October, 2004, the appointment of Si Xian Min as the president of the Company, and the resignation of Wang Chang Shun as the president of the Company were approved by the Board of Directors.

On 29 November, 2004, the appointment of Liu Shao Yong as a Director, and the resignation of Yan Zhi Qing as a Director for age reason were approved at the first extraordinary general meeting of the shareholders of the Company. On the same date, the Board of Directors of the Company elected Liu Shao Yong as the chairman of the Company.

On 31 December, 2004, the appointment of Si Xian Min as a Director, and the resignation of Wang Chang Shun as a Director were approved at the second extraordinary general meeting of the shareholders of the Company.

On 29 March, 2005, the appointment of Ren Ji Dong and He Zong Kai as the vice presidents of the Company, and the removal of Jiang Ping as a vice president of the Company were approved by the Board of Directors.

Biographical details of the Board of Directors, senior administrative officers and members of the Supervisory Committee are set out on pages 187 to 191 of this Annual Report.

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

As at 31 December, 2004, the interests and short positions of the Directors and Supervisors of the Company and their respective associates in the shares, underlying shares and 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 are as follows:

Name	The Company/ associated corporation	Types of interest	Type of shares	Number of shares held	% to the total issued H shares of the Company	% to the total issued domestic shares of the Company	% to the total issued share capital of the Company	Short position
Simon To	the Company	Interest of spouse (note 1)	H Shares	100,000	0.009%	–	0.002%	–

Note 1: The spouse of Mr. Simon To is the owner of these 100,000 H Shares of the Company and accordingly, Mr. Simon To, is taken to be interested in these 100,000 H Shares by virtue of the SFO.



Report of the Directors (Cont'd)

Save as disclosed above, as at 31 December, 2004, 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 he was 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.

The Company has received from each independent non-executive Director an annual confirmation of his independence pursuant to Rule 3.13 of the Listing Rules and the Company still considers such independent non-executive Directors to be independent.

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 contract of Mr. Liu Shao Yong and Mr. Si Xian Min which commenced from 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 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

In the year ended 31 December, 2004, 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.

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.

Report of the Directors (Cont'd)

(B) Very Substantial Acquisition and Connected Transaction

The Company, CSAHC, China Northern Airlines Company ("Northern Airlines"), a wholly owned subsidiary of CSAHC, and Xinjiang Airlines Company ("Xinjiang Airlines"), a wholly owned subsidiary of CSAHC, entered into a sale and purchase agreement (the "VSA Sale and Purchase Agreement") dated 12 November, 2004 pursuant to which the Company agreed to acquire, and CSAHC, Northern Airlines and Xinjiang Airlines agreed to sell certain airlines and airlines-related operations, assets and properties of Northern Airlines, Xinjiang Airlines and their respective subsidiaries, which included aircraft, engines, spare parts, aviation equipment and facilities, properties, office facilities, and other fixed, current and intangible assets. In addition, the Company will also assume all indebtedness in the aggregate sum of RMB13,438,191,000 owed by Xinjiang Airlines, Northern Airlines and their respective subsidiaries in connection with their civil aviation business.

The total consideration, including the assumption of the debts under the VSA Sale and Purchase Agreement was RMB15,397,524,000.

The purposes of entering into the VSA Sale and Purchase Agreement and the transactions thereunder were to bring various commercial benefits to the Company in terms of broadening its flight service network, increasing its fleet size and transportation capacity, reducing costs and boosting its overall efficiency, ultimately strengthening the Group's position as one of PRC's largest airlines and enhancing its value for its investors.

(C) Continuing Connected Transactions Between the Company, CSAHC and Their Respective Associates

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:

(a) *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 2006 by mutual agreement between the parties. The parties have mutually agreed that the agreement can be extended automatically.

For the year ended 31 December, 2004, the amount incurred by the Group for the import and export of the above equipment was RMB1,117,289,000, inclusive of agency commission of 1.5% above the contract prices paid to SAIETC.



Report of the Directors (Cont'd)

(b) Southern Airlines Advertising Company, which is 45% owned by the Company and 55% owned by CSAHC (“CSAHC”)

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

On 3 September, 2004, CSAHC increased its shareholdings from 10% to 55% by the creation of RMB3 million authorised share capital from RMB2 million. Such capital injection from CSAHC diluted the Company’s shareholdings of Southern Airlines Advertising Company from 90% to 45%.

The Company and Southern Airlines Advertising Company have entered into an agreement dated 22 May, 1997 for the provision of advertising services for a term extending from 22 May, 1997 to 22 May, 2000. After extension of three years, the parties have mutually agreed to extend the agreement for another three years to 22 May, 2006.

For the year ended 31 December, 2004, the amount incurred by the Group to Southern Airlines Advertising Company for advertising services was RMB1,166,000.

(c) 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:

- (a) 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;

Report of the Directors (Cont'd)

- (b) 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 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
- (c) 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.

The Company is not subject to any extra charges for depositing money with SA Finance. For the other financial services provided by SA Finance under the financial agreement, the Company is liable to pay SA Finance the standard charging rates set by the People's Bank of China. The PRC commercial banks also charge similar charging rates set by the People's Bank of China. The Company will make payment for such interest, fees and commissions in accordance with the payment terms of the separate agreements for the provision of loans or other financial services as might be entered into between the Company and SA Finance.

The Cap for the provision of deposit service under the financial agreement is set at RMB1 billion per year. The Company usually receives interest on its money deposited with SA Finance at rates which are more favourable than the benchmark interest rates set by the People's Bank of China, usually in the range between the benchmark interest rates set by the People's Bank of China and the inter-bank offer rates of interest. This arrangement allows the Company to achieve a more efficient use of its current capital, since the Company can enjoy better interest rates on depositing its current capital with SA Finance than the benchmark rates of interest set by the People's Bank of China that the PRC commercial banks can offer to the Company.

Subject to the entering into of further separate agreements, the Company can borrow from SA Finance at interest rates not higher than those set by the People's Bank of China for similar loans. In addition, the Company is not precluded under the financial agreement to borrow money from other PRC commercial banks where the terms and conditions are favourable. The Company can also enjoy the convenience of other financial services at the rates of fees and commissions set by the People's Bank of China, which are comparable to the rates charged by PRC commercial banks for similar services.

As of 31 December, 2004, the Group's deposits placed with SA Finance amounted to RMB406 million, which bore interest at the rate of 0.62% to 1.62% per annum.



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

The Company and Shenzhen Air Catering Company Limited 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 extended automatically.

For the year ended 31 December, 2004, the amount incurred by the Group to Shenzhen Air Catering Company Limited for the provision of in-flight meals was approximately RMB50,197,000.

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

The Company and GAMECO had entered into an Aircraft Maintenance and Engineering Agreement for the provision of aircraft repair and maintenance services. On 17 May, 1996, the Company and GAMECO entered into an agreement regarding the fee arrangement for the provision of such repair and maintenance services (the “Fee Agreement”). Pursuant to the Fee Agreement and subsequent agreements, GAMECO charged the Company for expendables at cost plus 15%, and labour costs at US\$30.0 per hour during 2004.

For the year ended 31 December, 2004, the amount incurred by the Group for such repair and maintenance services was RMB659,850,000.

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

CSAHC and the Australian Pilot College entered into an agreement dated 7 October, 1993 for the provision of pilot training in Australia to the cadet pilots of CSAHC (the “Training Agreement”). The Training Agreement will remain in force unless terminated by either party upon 90 days’ prior written notice to the other party. Pursuant to the 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, 2004, the amount paid by the Group to the Australian Pilot College for training services was RMB79,436,000.

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

The Company and Southern Airlines (Group) Economic Development Company 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, 2004, 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 RMB65,637,000.

Report of the Directors (Cont'd)

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

The Company and Nanland entered into a catering agreement dated 22 May, 1999 for the sale and purchase of in-flight meals for flights originating or stopping at the airport in Guangzhou. Pursuant to such agreement, Nanland will supply in-flight meals to the Company from time to time during the term from 22 May, 1999 to 22 May, 2000. The agreement will then be automatically renewed annually.

For the year ended 31 December, 2004, the amount paid by the Group to Nanland for the provision of in-flight meals was RMB105,756,000.

(i) *Ticket sales arrangements*

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

For the year ended 31 December, 2004, the aggregate amount of ticket sales of the Group conducted through the Agents was RMB32,008,000.

(j) *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 million per year.



Report of the Directors (Cont'd)

(D) 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.

(E) 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 RMB2,650,700 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.
- (d) The Company, CSAHC and Northern Airlines entered into a lease agreement dated 12 November, 2004, under which CSAHC and Northern Airlines lease to the Company certain buildings, facilities and other infrastructure related to the civil aviation businesses of Northern Airlines 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 RMB41,993,318 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 RMB41,993,318 per year.
- (e) The Company, CSAHC and Xinjiang Airlines entered into a lease agreement dated 12 November, 2004, under which CSAHC and Xinjiang Airlines lease to the Company certain buildings, facilities and other infrastructure related to the civil aviation businesses of Xinjiang Airlines 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 RMB5,797,909 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 RMB5,797,909 per year.

Report of the Directors (Cont'd)

- (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 RMB22,298,033 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 RMB22,298,033 per year.

(F) Comprehensive Services and Employee Benefits

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

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

(G) Ongoing Connected Transactions Between the Company, Northern Airlines, Xinjiang Airlines and Their Respective Associates

China Northern Airlines Company, a wholly owned subsidiary of CSAHC

Northern Airlines is principally engaged in commercial airline services in the PRC with its headquarters based in Shenyang, East Northern part of the PRC. Following the announcement of the consolidation and restructuring among CSAHC, Northern Airlines and Xinjiang Airlines on 11 October, 2002 (the "Consolidation and Restructuring"), Northern Airlines has become a wholly owned subsidiary of CSAHC and a connected person of the Company under the Listing Rules. The following agreements have been terminated following the acquisition of the core operational assets of Northern Airlines and Xinjiang Airlines on 31 December, 2004.

Xinjiang Airlines Company, a wholly owned subsidiary of CSAHC

Xinjiang Airlines is principally engaged in commercial airline services in the PRC with its headquarters based in Urumqi, Xinjiang. Following the Consolidation and Restructuring, Xinjiang Airlines has become a wholly owned subsidiary of CSAHC and a connected person of the Company under the Listing Rules. The following agreements have been terminated following the acquisition of the core operational assets of Northern Airlines and Xinjiang Airlines on 31 December, 2004.

(a) *In-flight Meals Arrangement with Northern Airlines*

Nanland has been providing and will provide in-flight meals to Northern Airlines. Pursuant to an agreement dated 23 June, 2000, Nanland has been providing in-flight meals to Northern Airlines from time to time for a period of one year. The agreement will then be automatically renewed annually. For the year ended 31 December, 2004, the amount paid by Northern Airlines to Nanland for the provision of in-flight meals was approximately RMB5,221,000.



Report of the Directors (Cont'd)

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

For the year ended 31 December, 2004, the amount paid by the Group to Northern Airlines for the provision of in-flight meals was approximately RMB3,303,000.

(b) *In-flight Meals Arrangement with Xinjiang Airlines*

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

For the year ended 31 December, 2004, the amount paid by Xinjiang Airlines to Nanland for the provision of in-flight meals was approximately RMB2,326,000.

Pursuant to an agreement dated 20 September, 1999, Xinjiang Airlines has been providing and will provide in-flight meals to the Group for a period of one year. The agreement will then be automatically extended annually. The amount paid by the Group to Xinjiang Airlines for the provision of in-flight meals for the year ended 31 December, 2004 was approximately RMB2,298,050.

(c) *Ticket Sales Arrangement with Northern Airlines*

In accordance with the relevant requirement and industry practice, the Group has entered into ticket agency arrangement with Northern Airlines for the sale of the Group's air tickets by Northern Airlines and for the sale of Northern Airlines air tickets by the Group. The selling party charges a commission in the amount of 3% of the ticket price for domestic tickets and 5% to 12% of the ticket price for Hong Kong regional and international tickets. These commission rates are based on the rates stipulated by the CAAC and IATA. The amount of commission paid by Northern Airlines to the Group for the year ended 31 December, 2004 was approximately RMB160,848,000. The amount of commission paid by the Group to Northern Airlines for the year ended 31 December, 2004 was approximately RMB13,074,000.

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

(d) *Ticket Sales Arrangement with Xinjiang Airlines*

The Group has entered into ticket agency arrangement with Xinjiang Airlines for the sale of the Group's air tickets by Xinjiang Airlines and for the sale of Xinjiang Airlines air tickets by the Group. The selling party charges a commission in the amount of 3% of the ticket price for domestic tickets and 5% to 12% of the ticket price for Hong Kong regional and international tickets. These commission sales are based on the rates stipulated by the CAAC and IATA. The amount of commission paid by Xinjiang Airlines to the Group for the year ended 31 December, 2004 was approximately RMB78,207,000. The amount of commission paid by the Group to Xinjiang Airlines for the year ended 31 December, 2004 was approximately RMB7,585,000.

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

Report of the Directors (Cont'd)

The Independent Non-Executive Directors of the Company have confirmed to the Board of Directors of the Company that they have reviewed the connected transactions described in (C) through (G) above (the "Reviewed Transactions") and have concluded that:

- (a) the Reviewed Transactions have been entered into by the Group in the ordinary and usual course of its business;
- (b) the Reviewed 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 Reviewed Transactions have been performed in accordance with the terms of the relevant agreement governing each such Reviewed Transaction on terms that are fair and reasonable so far as the shareholders of the Company are concerned.

The auditors of the Company have reviewed the Reviewed Transactions and provided the Board of Directors with a letter stating that:

- (a) the Reviewed Transactions have been approved by the Board of Directors;
- (b) nothing came to their attention that caused them to believe that the Reviewed Transactions:
 - were not conducted in accordance with the terms of the relevant agreement; and
 - have exceeded the Cap disclosed in the previous announcement(s).

DONATIONS

During the year, the Group made donations for charitable purposes amounting to RMB9 million.

DESIGNATED DEPOSITS AND OVERDUE TIME DEPOSITS

As at 31 December, 2004, 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.



Report of the Directors (Cont'd)

MATERIAL LITIGATION

The Company is currently involved 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 is in the course of its winding up proceedings, all the rights and benefits of UASSC in connection with the claim have been transferred to the plaintiff. The Company, as one of the defendants to the Litigation, is being claimed for unspecified damages for breach of the agreement. The Company has filed an objection in respect of the jurisdiction of the court, and has 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 has filed an appeal.

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

25 April, 2005