

# Business Overview



## Business Review of the Company and Air China Cargo

**Passenger services:** In 2005, the Company's passenger traffic reached 52,405 million RPKs, representing an increase of 12.3% from 2004. Passenger traffic from international routes, domestic routes and Hong Kong and Macau routes increased by 10.9%, 13.3% and 14.2% respectively. The higher growth in domestic and Hong Kong and Macau routes compared with international routes reflected the robust growth potential of the domestic and Hong Kong and Macau aviation markets. For 2005, the number of passengers carried increased by 13.0% from 2004 to 27.69 million, available seat kilometres of the Company increased by 8.9% from 2004 to 70,662 million kilometres, while passenger load factor increased by 2.3 percentage points from 2004 to 74.2% and income per RPK increased by 1.8% from 2004 to RMB0.57.

**Cargo services:** During 2005, turnover volume of cargo and mail of the Company increased by 6.9% from 2004 to 2,760 million RFTKs. Cargo and mail carried increased by 10.2% from 2004 to 733,000 tonnes. On 18 December 2005, the first B747-400 cargo aircraft acquired by Air China Cargo, a 51% owned joint venture of the Company, was delivered to Beijing International Airport, which enabled Air China Cargo to catch up with the growth of the industry in terms of transport capacity. Subsequent to that, three more B747-400 cargo aircraft and three TU204 cargo aircraft will join the fleet of Air China in succession. For 2005, available freight tonne-kilometres of the Company increased by 4.5% to 5,063 million, while cargo and mail load factor increased by 1.2 percentage points from 2004 to 54.5%, and cargo yield per RFTK increased by 2.0% to RMB2.03.

## Business Review of Air Macau

The Company holds 51% of the capital share of Air Macau through China National Aviation Corporation (Macau) Company Limited, a wholly-owned subsidiary of China National Aviation Company Limited. Air Macau was established in Macau in 1994 and is a domestic airline in Macau. It commenced operation in November 1995 under a franchise agreement entered into with the Macau government, pursuant to which Air Macau enjoys an exclusive franchise for a term of 25 years until 2020. Key operating data of Air Macau in 2005 are set out as follows:

	2005	2004	Change (%)
<b>Traffic</b>			
<b>RPK (in millions)</b>	<b>2,449.8</b>	2,145.6	14.2
<b>RFTK (in millions)</b>			
– passenger aircraft	<b>22.5</b>	23.2	(3.0)
– cargo aircraft	<b>147.5</b>	84.4	74.8
<b>Passengers carried (in thousands)</b>	<b>2,059.6</b>	1,808.0	13.9
<b>Cargo carried (in tonnes)</b>			
– passenger aircraft	<b>19,251</b>	19,601	(1.8)
– cargo aircraft	<b>132,662</b>	83,683	58.5
<b>Capacity</b>			
<b>ASK (in millions)</b>	<b>3,425.4</b>	3,068.2	11.6
<b>ATK (in millions)</b>			
– passenger aircraft	<b>392.44</b>	349.20	12.4
– cargo aircraft	<b>206.92</b>	117.14	76.6

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	2005	2004	Change (%)
<b>Load Factor</b>			
<b>Passenger load factor (RPK/ASK)</b>	<b>72</b>	70	2
<b>Cargo load factor (RFTK/AFTK)</b>			
– passenger aircraft	<b>45.1</b>	54.8	(9.7) ppt
– cargo aircraft	<b>71.3</b>	72.1	(0.8) ppt
<b>Yield</b>			
<b>Yield per RPK (avos)</b>	<b>65</b>	65	–
<b>Yield per RFTK (MOP)</b>			
– passenger aircraft	<b>5.05</b>	4.97	1.61
– cargo aircraft	<b>4.85</b>	4.88	(0.61)

### Business Review of Associated Airlines

#### Shandong Airlines Company Limited (“Shandong Airlines”)

The Company holds 22.8% of the capital share of Shandong Airlines. Shandong Aviation Group, which is owned as to 48.0% by the Company, also holds 42.0% of the shares of Shandong Airlines. During 2005, total traffic turnover of Shandong Airlines increased by 28.9% from 2004 to 439 million tonne kilometres, while passengers carried increased by 33.8% from 2004 to 4.01 million person-time.

#### Shenzhen Airlines Company Limited (“Shenzhen Airlines”)

The Company holds 25% of the capital share of Shenzhen Airlines. During 2005, total traffic turnover of Shenzhen Airlines increased by 23.4% from 2004 to 840 million tonne kilometers, while passengers carried increased by 18.5% from 2004 to 5.73 million person-time.

### Hub Building

During 2005, through expanding transport capacity, securing time slots and improving flight connection, the Company continued to strengthen hub building in Beijing, Chengdu and Shanghai and, in particular, reinforced its control over the Beijing hub.

Beijing is one of the most important international gateways and domestic transit hubs in China. The Company has the most extensive route network with Beijing as its base. In 2005, passenger throughput of the Company at the Beijing base was 16.57 million, representing a market share of 44.4%, while cargo and mail throughput was 475,500 tonnes, representing a market share of 50.2%. During the reporting period, the Company increased the number of aircraft serving the Beijing hub to 104, which was 12 aircraft more compared with 2004. The time slots in the Beijing Capital International Airport were also increased to 2,750 time slots per week. As for flight connection, the Company reinforced its advantage in transit connection of international and domestic networks, increasing the total number of connecting flights available per week by 23% to 36,400. Average number of connecting flights increased from 14.3 in 2004 to 16.5.

Compared with other domestic airlines, the Company has the most extensive route network in southwestern China with particular strengths in main routes within the region, such as Chengdu-Lhasa and Chengdu-Jiuzhai routes. In 2005, the Company reinforced transit connection function of Chengdu as regional hub, and preliminarily actualised two-way connection arrangement between western China and South East Asia. As a result, passenger traffic through connecting flights increased significantly. Chengdu has become an important hub for flights connecting Jiuzhai, Lhasa and domestic and international routes. Network coverage of the Chengdu hub in the western regional market has been gradually increasing.

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The Company has a long history of operation in Shanghai, and is currently providing domestic and international passenger and cargo services at both Shanghai Hongqiao Airport and Shanghai Pudong International Airport. As Shanghai is growing into an important hub in the global aviation network, the Company accelerated the development of its operation in the Shanghai international gateway and expanded the transport capacity of routes originally departing from Shanghai. In 2005, the Company established four new routes from Shanghai to Guangzhou, Kunming, Xiamen and Wuhan respectively. During the year, the Company's transport capacity in Shanghai increased by 5 aircraft from 2004 to 28 aircraft in 2005.

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### Route Network

As a major part of hub building, the Company continued to improve and optimize its route network structure. As for passenger services, the Company increased flight frequency and made appropriate adjustments on the transport capacity of routes with substantial seasonal fluctuation. Top 20 domestic routes with the highest revenues from passenger services received a boost in transport capacity and such growth accounted for 46.5% of the total growth in transport capacity in the PRC. On the international front, emphasis was placed on routes to and from Europe, America and Korea with 1,283 more flights schedules, resulting in marked improvement in the overall efficiency of these routes. As for cargo services, regular flights serving the Chengdu-Beijing-Frankfurt route was formally launched on 18 December 2005. Being the first regular international cargo route at Chengdu, this route not only strengthened the position of the Company in western China, but also contributed substantially to the economic development in the region.

Leveraging on its hub network strengths, the Company further expanded its transit business. In 2005, the Company launched quasi-international flights (虛擬國際航班) from eight cities, including Chengdu, to Beijing. In addition, it also rolled out one-off transit services for flights from 8 terminals, including Guangzhou terminal, or Hong Kong to domestic destinations with transit at Beijing. The Company also entered into cooperation with Air Canada and launched one-off boarding services in the PRC and Canada. In 2005, the Company's transit and connecting flights served 718,000 passengers, fully reflecting the value of its hub network.

### Fleet Maintenance

The fleet of the Company and Air China Cargo continued to expand. During the year, there was a net increase of 25 aircraft in the fleet. As at 31 December 2005, we and Air China Cargo operated a fleet of 176 aircraft with an average age of 8.1 years (2004: 8.1 years). Details of the fleet are set out in the table below:

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Aircraft Model	No. of Aircraft			Subtotal
	Self-owned	Finance Lease	Operating Lease	
<b>Passenger Aircraft</b>				
Airbus	22	8	7	37
Boeing	64	38	26	128
CRJ-200	–	–	3	3
<b>Cargo Aircraft</b>	<b>5</b>	<b>–</b>	<b>1</b>	<b>6</b>
<b>Business Jet</b>	<b>–</b>	<b>–</b>	<b>2</b>	<b>2</b>
<b>Total</b>	<b>91</b>	<b>46</b>	<b>39</b>	<b>176</b>

As at 31 December 2005, Air Macau operated a fleet of 18 aircraft (2004: 15 aircraft), of which 13 were passenger aircraft and 5 were cargo aircraft.

To improve our service quality to high-end customers and expand the Company's market share in long haul business travel segment that offers higher yield, the Company embarked on improving first class and business class cabins of certain passenger aircraft, which were mainly used in for long haul routes, including flights to Frankfurt and New York. As at 31 December 2005, renovation work was completed for 5 aircraft, including 4 B747-400 aircraft and 1 A340-300 aircraft.

On 26 January 2005, the Company and Air China Group Import and Export Trading Co. entered into a A330-200 aircraft purchase agreement with Airbus S.A.S., pursuant to which the Company agreed to purchase 20 A330-200 aircraft from Airbus S.A.S., mainly for serving routes to international destinations in Europe, Australia and North America as well as certain major domestic routes to destinations such as Lhasa.

On 28 January 2005, the Company, other PRC airlines, China Aviation Supplies Import and Export Group Corporation and Boeing Company entered into a framework agreement regarding the acquisition of Boeing 787 aircraft. On 8 August 2005, the Company and Boeing Company entered into a formal agreement for the purchase of 15 Boeing 787 aircraft.

On 22 April 2005, the Company entered into an agreement with ILFC for the lease of 2 B737-800 aircraft from ILFC. On 19 May, the Company entered into an agreement with Sunrock for the lease of 5 B737-800 aircraft from Sunrock. On 2 June, the Company entered into an agreement with GECAS for the lease of 5 B737-800 from GECAS. The Company leased a total of 12 Boeing 737-800 aircraft from these companies.

On 27 March 2005, the Company and Shandong Airlines entered into an agreement whereby the Company wet leased 3 CRJ-200 aircraft from Shandong Airlines.

On 8 August 2005, the Company and Hong Kong Dragon Airlines Limited ("Dragonair") entered into an agreement whereby the Company wet leased 1 A330 and 1 A320 aircraft from Dragonair.

The above aircraft purchases and leases will further enhance the passenger transportation capacity of the Company's fleet and in turn provide more comfortable service to passengers.

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### Market Expansion

By strengthening connecting flight management, the Company provided effective support to the hubs and gateway with operations in the secondary markets. Sales efforts of the first and business classes were substantially reinforced, while international flights with one-off boarding service were rolled out at a faster pace. The Company also enriched its connecting flight service categories. Leveraging on its centralised control structure, the Company optimised the number of subclasses with the aim of maximizing the revenue of its routes.

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For 2005, income from connecting flights increased by 16.1% from 2004 to RMB8,830 million. The number of direct sales customers reached 2,105 while frequent flyers membership expanded by 960,000 members to 3.01 million members. The Company sold 4.20 million electronic tickets with an aggregate value of RMB3,540 million, representing an increase of 51% from 2004 and accounting for nearly 20% in the total sales of electronic tickets in the PRC.

A network marketing strategy was adopted for cargo services. The Company established regional sales centres in overseas markets and consolidated regional sales resources in the domestic market with a focus on developing the sales network in hub regions, thereby consolidating its sales resources and the relevant transport capacity. Air China Cargo improved the load factor and yield rate of return flights by reducing the proportion of block cargo space, and promoting sales of round trip tickets and connecting flight tickets. The Company also improved domestic sales by carrying out direct sales and the "Mail Revival Scheme" (郵件復興計劃).

### Business Cooperation for Mutual Benefits

The Company actively promoted bilateral cooperation. In 2005, it entered into codeshare agreements with Cathay Pacific Airways Limited ("Cathay Pacific"), Kuwait Airways Corporation, Qatar Airways and Varig Brasil Airlines of Italy, enlarging its codeshare partnership to 19 airlines. In addition, the Company also entered into 108 special prorate arrangements (SPA) with 84 airlines.

As at the end of 2005, the Company entered into codeshare arrangements for a number of international and Hong Kong and Macau passenger flight routes with 16 airlines, including United Airlines, Cathay Pacific and All Nippon Airways. For domestic routes, the Company entered into codeshare arrangements with three airlines, namely China Southern Airlines Company Limited, Shanghai Airlines Company Limited and Shandong Airlines, on a number of domestic routes.

For cargo services, Air China Cargo, a 51% owned joint venture of the Company, entered into codeshare arrangements with 6 airlines, including Lufthansa German Airlines (jointly operating route with the Company) and Nippon Cargo Airlines.

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### Post Balance Sheet Events

On 17 January 2006, the Company and Air China Group Import and Export Trading Co. entered into an aircraft purchase agreement with Boeing Company for the purchase of 10 B737-800 aircraft from Boeing Company.

On 28 March 2006, when the first extraordinary general meeting and class meeting of the Company in 2006 were held, a resolution in relation to the public offering of up to 27,000,000,000 Renminbi denominated ordinary shares (i.e. A Shares) by the Company in the PRC was approved.

On 24 January 2006, CNAC, a subsidiary of the Company, entered into an agreement with Shun Tak Air Transport Limited and its subsidiaries ("Macau Asia Express Agreement") in respect of the establishment of a joint venture in Macau named Macau Asia Express Limited ("Macau Asia Express"), which would primarily engage in the provision of low-cost air transportation services in Macau. Taking into account indirectly held interests, CNAC holds 43.7% equity interests in Macau Asia Express.