Management's Discussion and Analysis of Financial Position and Operating Results

Financial statements of the Group set out from pages 55 to 135 of the annual report for the year, comprising the consolidated income statement, consolidated balance sheet, consolidated statement of changes in equity, consolidated cash flow statement, balance sheet and notes to financial statements, were prepared in accordance with International Financial Reporting Standards ("IFRS"). The following discussion and analysis are designed to assist the reader in understanding the information provided in this annual report so as to fully comprehend the financial position of the Group as a whole.

Profit From Operations and Net Profit Attributable to Equity Holders

In 2005, the Group's profit from operations was RMB3,674 million, representing a decrease of 18.1% compared with 2004. Net profit attributable to equity holders amounted to RMB2,406 million, representing a decrease of 0.9% compared with 2004. The decrease in profit from operations was mainly due to the rising jet fuel price.

The consolidated financial statements include the operating results of all subsidiaries of the Group. During the reporting period, share of profits from associates was RMB225 million, representing a decrease of 51.5% from the corresponding period last year, primarily due to the decrease in profits from three associates, namely Dragonair, Shenzhen Airlines and Shandong Airlines.

Profit Contribution by Business Segments

(RMB'000)	**2005**	2004	Change (%)
Airline operations	**3,367,949**	4,146,402	(18.8)
Engineering services	**153,779**	93,269	64.9
Airport terminal services	**123,679**	203,133	(39.1)
Others	**28,409**	42,447	(33.1)
Profit from operations	**3,673,816**	4,485,251	(18.1)

Earnings Per Share

In 2005, the Group's earnings per share was RMB25.5 cents, a decrease of 29.2% compared with RMB0.36 for 2004. This was mainly due to the initial public offering of 2,550,618,182 shares upon the Company's listing in late 2004 and the issue of 382,592,727 shares pursuant to the over-allotment option in the beginning of 2005, which increased the weighted average number of shares compared with last year. Details of earnings per share are set out in note 14 to the financial statements.

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Operating Revenue

In 2005, the Group's operating revenue was RMB38,291 million, representing an increase of 14.2% compared with last year. Increase in the Group's operating revenue was mainly attributable to the rapid growth of air traffic revenue, which increased by 14.5% in 2005. In 2005, the daily utilization of aircraft averaged at 10.4 hours, increased 0.2 hours as compared with 2004.

Revenue Contribution by Business Segments

(RMB'000)	**2005**	2004	Change (%)
Airline operations	**37,380,669**	32,766,164	14.1
Engineering services	**376,437**	296,775	26.8
Airport terminal services	**320,477**	287,905	11.3
Others	**213,383**	169,913	25.6
Total operating revenue	**38,290,966**	33,520,757	14.2

The Group's operating revenues principally included air traffic and other operating revenue. Most of our operating revenue was from air traffic revenue, which represented 92.2% of the Group's total revenue in 2005, while the other operating revenue represented only 7.8% of the total operating revenue. Among air traffic revenues in 2005, 89.5% was generated from passenger services and 10.5% was from cargo and mail transport.

The passenger transport income increased by 14.2% to RMB31.58 billion in 2005 from RMB27.67 billion in 2004. It was mainly attributable to the increase in transport capacity, passenger load factor and profitability level. The Company's transport capacity in terms of available seat kilometres increased by 8.9% to 70.66 billion in 2005 from 64.89 billion million in 2004 . The Company's passenger load factor rose to 74.2% in 2005 as compared with 71.9% in 2004. The Company's passenger yield increased by 1.8% to RMB0.57 in 2005 from RMB0.56 in 2004.

Revenue from cargo and mail increased by 17.2% to RMB3,716 million in 2005 from RMB3,170 million in 2004. Such increase was primarily as a result of the improvements in the traffic capacity, cargo and mail load factor and profitability level. Cargo transport capacity in terms of available freight tonne-kilometres increased by 4.5% to 5,063 million in 2005 from 4,843 million in 2004.

The load factor of cargo transport increased to 54.5% in 2005 from 53.3% in 2004. The overall cargo yield increased by 2% to RMB2.03 for each yield tonne kilometre in 2005 from RMB1.99 for each yield tonne kilometre in 2004.

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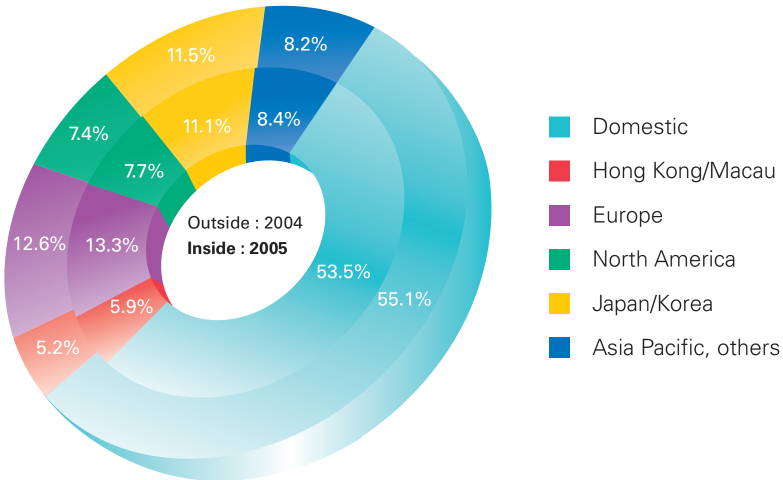
Revenue Contribution by Geographical Segments

(RMB'000)	**2005**	2004	Change (%)
Domestic	**20,490,055**	18,482,949	10.9
Hong Kong/Macau	**2,269,256**	1,744,590	30.1
Europe	**5,081,774**	4,232,489	20.1
North America	**2,964,247**	2,477,214	19.7
Japan/Korea	**4,250,255**	3,846,973	10.5
Asia Pacific, others	**3,235,379**	2,736,542	18.2
Operating revenue	**38,290,966**	33,520,757	14.2



Operating Expenses

The operating expenses of the Group primarily comprise jet fuel costs, take-off, landing and depot charges, depreciation, aircraft maintenance, repair and overhaul expenses, employee compensation costs and air catering charges. In 2005, the Group recorded RMB34.617 billion in operating expenses, representing an increase of 19.2% compared with RMB29.036 billion in 2004, primarily as a result of the rising jet fuel costs.

(RMB'000)	**2005**	2004	Change (%)
Jet fuel	**11,777,129**	8,353,752	41.0
Take-off, landing and depot charges	**4,442,585**	4,230,349	5.0
Depreciation	**4,512,680**	3,463,252	30.3
Aircraft maintenance, repair and overhaul	**1,341,773**	2,835,648	(52.7)
Employee compensation costs	**3,406,825**	2,921,322	16.6
Air catering expenses	**1,242,933**	1,171,784	6.1
Others	**7,893,225**	6,059,399	30.3
Total Operating Expenses	**34,617,150**	29,035,506	19.2

Jet fuel costs increased by 41.0% to RMB11.7 billion in 2005 from RMB8,354 million in 2004 and accounted for 34.0% of operating expenses as compared with 28.8% in 2004. This increase was primarily due to jet fuel price rise and the increased consumption of jet fuel as a result of the increased number of flights operated.

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Take-off, landing and depot charges increased by 5% to RMB4,443 million in 2005 from RMB4,230 million in 2004, primarily due to the increased number of flights operated.

Depreciation expenses increased by 30.3% to RMB4,513 million in 2005 from RMB3,463 million in 2004, primarily due to the accounting changes and fleet expansion. Details on the accounting changes are set out in note 2 to the financial statements.

Aircraft maintenance, repair and overhaul expenses decreased by 52.7% to RMB1,342 million in 2005 from RMB2,836 million in 2004, primarily due to accounting changes. Details on the accounting changes are set out in note 2 to the financial statements.

Employee compensation costs increased by 16.6% to RMB3,407 million in 2005 from RMB2,921 million in 2004, primarily due to the increased flight hours, growth of the number of employee, and increased income of employee.

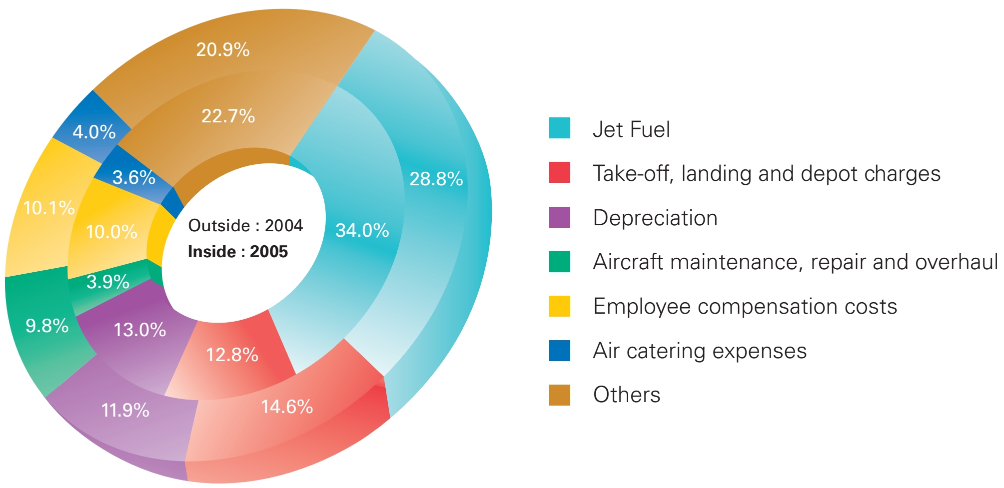
Air catering charges increased by 6.1% to RMB1,243 million in 2005 from RMB1,172 million in 2004, primarily due to an increase in the number of passengers carried.

Other operating expenses, including aircraft and engines operating lease expenses, other flight operation expenses, selling and marketing expenses and general and administrative expenses, increased by 30.3% to RMB7,893 million in 2005 from RMB6,059 million in 2004.

Expenses on operating leases of aircrafts and engines increased from RMB1,071 million in 2004 to RMB1,531 million in 2005, mainly due to the increase in operations with leased aircrafts as well as wet lease of aircrafts from Air Macau Company Limited, Hong Kong Dragon Airlines Limited and Shandong Airlines Company Limited.

Other flight operation expenses increased to RMB3,745 million in 2005 from RMB2,698 million in 2004, primarily due to the adjustments in the accounting policies and the increase in CAAC Infrastructure Development Fund as a result of the increased number of routes.

Selling and marketing expenses increased to RMB1,775 million in 2005 from RMB1,387 million in 2004, primarily due to higher related expenses as a result of increased sales income.



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Analysis of Assets

As at 31 December 2005, the Group had total assets of RMB68.2 billion, representing an increase of 2.3% from 31 December 2004. Of the total assets, RMB7,540 million of current assets accounted for 11.1%, while RMB60.66 billion of non-current assets accounted for 88.9%. Among the current assets, cash and cash equivalents were RMB2,248 million, decreasing by 76.1% as compared with 31 December 2004, while trade receivables increased by 16.9% as compared with 31 December 2004 to RMB2,764 million. Among the non-current assets, property, plant and equipment were RMB47.191 billion, representing an increase of 8.6% as compared with 31 December 2004.

Assets Mortgage

As at 31 December 2005, the Group mortgaged certain aircraft with an aggregate carrying value of approximate RMB26.958 billion (compared with RMB28.585 billion as at 31 December 2004) pursuant to certain loan and finance lease agreements. In addition, certain bank deposits of the Group in the sum of approximately RMB177 million (compared with approximately RMB117 million as at 31 December 2004) were pledged against the Group's certain loans and obligations in respect of certain operating leases and financial derivatives.

Debt Structure of the Group

	Bank, other loans and corporate bonds		**Obligations under finance leases**	
(In RMB'000)	**2005/12/31**	2004/12/31	**2005/12/31**	2004/12/31
Within one year	**10,401,170**	8,806,051	**1,954,873**	1,705,146
In the second year	**2,747,158**	3,063,899	**1,949,802**	1,943,630
In the third to fifth years, inclusive	**4,699,654**	6,215,259	**6,071,492**	6,722,448
After five years	**5,376,067**	3,617,464	**57,377**	1,910,163
Total	**23,224,049**	21,702,673	**10,033,544**	12,281,387

A significant portion of the Group's debts will fall due within one year. The Group expects to meet its liabilities with bank loans, internal resources and other resources as they fall due. The Group is not exposed to any insolvency risk for the reasons set out in the sections titled "Liquidity and Capital Resources" and "Objective and Policy of Financial Risk Management".

Gearing Ratio

As at 31 December 2005, the Group's gearing ratio, which represents total liabilities divided by total assets, was 68.4%, which dropped by 5 percentage points from 73.0% as at 31 December 2004.

Interest Expense

In 2005, interest expense of the Group decreased from RMB1.824 billion in 2004 to RMB1.773 billion, primarily due to the repayment of certain bank loans and decrease in obligations under finance leases.

Interest Cover

In 2005, earnings before finance revenue and finance costs (including interest expense, interest income, exchange gains/losses, net gains on fuel derivatives and dividend income from available-for-sale investments), enterprise income taxes, share of profits less losses of associates, dilution gains on investments and depreciation ("EBITDA") as computed under IFRS, divided by interest expense, were 4.62 times, compared with 4.36 times in 2004. The increase in interest cover was attributable to the decrease in interest expense and rise in EBITDA.

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Capital Commitments and Contingent Liabilities

As at 31 December 2005, capital commitments of the Group increased substantially from RMB11.832 billion as at 31 December 2004 to approximately RMB38.514 billion, primarily due to commitments in the purchase of certain aircraft and relevant flight equipment to be delivered in the coming years, and for the construction of certain properties.

As at 31 December 2005, the Group had contingent liabilities in respect of bank and other guarantees and other matters arising in the ordinary course of business. Details of contingent liabilities of the Group will be set out in note 41 to the financial statements.

Liquidity and Capital Resources

The Group finances its operations through cash inflow from operating activities and bank loans. Like many other airline groups in the PRC, the Group has been operating with a net current liabilities position. As at 31 December 2005 and 31 December 2004, net current liabilities of the Group were RMB16 billion and RMB9.053 billion respectively. The increase in net current liabilities was primarily due to a decrease in current assets, in particular, a RMB7.165 billion decrease in cash and cash equivalents.

In 2005, the Group's net cash inflow from operating activities decreased by 2% to RMB6.048 billion from RMB6.156 billion in 2004. Net cash outflow from investing activities in the same period increased by 151% to RMB12.500 billion from RMB4.979 billion in 2004, primarily due to an increase in prepayment for purchase of aircraft. The Group recorded a net cash outflow in financing activities of RMB0.766 billion, primarily due to the repayment of bank loans and the distributions to shareholders pursuant to the Group's restructuring in 2004. The major sources of finance of the Group are bank loans. As at 31 December 2005, the Group had obtained bank facilities of up to RMB78.570 billion from a number of banks in the PRC.

As at 16 September 2005, the Company successfully issued corporate bonds of RMB3 billion in aggregate. The bonds received overwhelming subscription from investors upon issue and were completely taken up on the first date with more than 10-time oversubscription. Prior to this, on 25 May 2005, the Company has successfully issued short-term commercial papers in the amount of RMB2 billion.

Capital Expenditure

For 2005, the capital expenditure of the Company amounted to RMB10.547 billion. Among the capital expenditure of the Company, total investment in aircraft was RMB9.069 billion, including a prepayment of RMB6.183 billion for purchasing aircraft from 2006 onwards.

Other investments in capital expenditure items were RMB1.478 billion, which mainly involved the improvement of first class and business class cabins of certain aircraft, ancillary projects in No. 3 Terminal of Beijing International Airport, as well as certain long-term investment projects.

The Group intended to fund its capital expenditure with internal generated source of funds, bank loans, corporate bonds and the proceeds from the proposed issue of A shares.

Objective and Policy of Financial Risk Management

The Group is exposed to the fluctuations in jet fuel price during its ordinary operations. International jet fuel prices have been historically, and will in the future continue to be, subject to price volatility and fluctuations in supply and demand. The Group's strategy for managing its jet fuel price risk aims to provide itself with protection against sudden and significant price increases. Subject to the applicable laws of the PRC, the Group started to engage in fuel hedging transactions in March 2001. The subjects of hedging instruments were mainly Singapore jet fuel and Brent crude oil derivatives that are closely linked to jet fuel. In 2005, the Group applied hedging to 12.3% of the procured jet fuel, and the net gain on jet fuel derivatives was RMB222 million, representing an increase of 440% compared with 2004.

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Foreign liabilities constitute a large proportion of the Group's liabilities. As at 31 December 2005, loans denominated in US dollar and Hong Kong dollar were equivalent to RMB11.352 billion and RMB224 million respectively. Appreciation of the Renminbi will benefit the Company with exchange gains. In 2005, the net exchange gains of the Group was RMB918 million (2004: net exchange losses of RMB55 million). The foreign exchange income and expenses of the Group are generally the same. The Group adopted "natural immunity" method to achieve a matching structure of income and expenses by adjusting the proportion of its liabilities in foreign currencies. The Company will continue to avoid exposure to the risk of exchange rate fluctuation by adopting a strategy that matches the income and payment in certain principal currencies.

Information on financial risk management objectives and polices in other aspects of the Group's operations will be set out in note 44 to the financial statements.