# Report of the Directors

The board of directors (the "Board") of the Company hereby presents this report and the audited consolidated financial statements of the Group for the year ended 31 December 2005 to all the shareholders.

## GROUP ACTIVITIES AND RESULTS

The Group is a provider of air passenger, air cargo and airline-related services.

The results of the Group for the year ended 31 December 2005 and the financial positions of the Company and the Group as of the same date are set out in the audited financial statements on pages 55 to 135 of this annual report.

## FIVE-YEAR FINANCIAL HIGHLIGHTS

The summary of the Group's results and balance sheets for the five years from 2001 to 2005 are set out under the section headed "Financial Summary" on page 3 of this annual report.

## SHARE CAPITAL



The Company issued 2,805,680,000 H shares in 2004 (including 255,061,818 H shares sold by selling shareholders). On 7 January 2005, the international underwriters of the Company's initial public offering had exercised in full the over-allotment options referred to in the Company's prospectus dated 3 December 2004 (the "Prospectus") for over-allocation of shares (equivalent to approximately 15% of the H shares initially offered under the global offering) solely for satisfying over-allocation under the international offering. The Company issued and allotted 382,592,727 over-allotment shares at HK$2.98 per H Share (being the offer price per H Share under the international offering, exclusive of brokerage, SFC transaction levy, investor compensation levy and Stock Exchange trading fee). The net proceeds of approximately HK$1.1 billion (after deduction of various costs, which mainly comprise underwriting commission, Stock Exchange trading fee, SFC transaction levy and investor compensation levy) from the issue of 382,592,727 over-allotment shares will be used by the Company for the acquisition of various aircraft and repayment of liabilities due within one year.

Additionally, due to the reduction of State-owned shares, 29,749,686 state-owned legal person shares and 8,509,587 Non-H foreign shares were converted into H shares with a nominal value of RMB1.00 each.

As at 31 December 2005, the Company's total share capital amounted to RMB9,433,210,909, divided into 9,433,210,909 shares with a nominal value of RMB1.00 each. As at 31 December 2005, the share capital structure of the Company is as follows:

| | As at 31 December 2004 | | **As at 31 December 2005** | |
|---|---|---|---|---|
| **Class of shares** | Number of shares | Percentage of total issued share capital | **Number of shares** | **Percentage of total issued share capital** |
| Domestic shares | 4,855,945,675 | 53.65% | **4,826,195,989** | **51.16%** |
| Non-H Foreign shares | 1,388,992,507 | 15.35% | **1,380,482,920** | **14.63%** |
| H shares | 2,805,680,000 | 31.00% | **3,226,532,000** | **34.21%** |
| Total | 9,050,618,182 | 100% | **9,433,210,909** | **100%** |

# Report of the Directors

## SIGNIFICANT INTERESTS AND SHORT POSITIONS IN SHARES AND UNDERLYING SHARES OF THE COMPANY

As at 31 December 2005, the interests and short positions of the following persons (other than the Company's directors, chief executives or supervisors) in the shares and underlying shares or equity derivatives of the Company as recorded in the register of the Company required to be kept pursuant to Section 336 of the Securities and Futures Ordinance of Hong Kong (the "SFO") were as follows:

| Name of shareholder | Class and number of shares held | Nature of ownership | Percentage of the relevant class of shares in the Company | Percentage of the total issued share capital of the Company |
|---|---|---|---|---|
| CNAHC | 4,826,195,989 Domestic shares | Beneficial owner | 100% | 51.16% |
| CNAHC[(1)] | 1,380,482,920 Non-H Foreign shares | Attributable interest | 100% | 14.64% |
| CNACG | 1,380,482,920 Non-H Foreign shares | Beneficial owner | 100% | 14.64% |
| Cathay Pacific | 943,321,091 H Shares | Beneficial owner | 29.24% | 10.00% |
| Swire Pacific Limited[(2)] | 943,321,091 H Shares | Attributable interest | 29.24% | 10.00% |
| John Swire & Sons Limited[(2)] | 943,321,091 H Shares | Attributable interest | 29.24% | 10.00% |
| John Swire & Sons (H.K.) Limited[(2)] | 943,321,091 H Shares | Attributable interest | 29.24% | 10.00% |
| Temasek Holdings (Private) Limited[(3)] | 400,450,000 H Shares | Attributable interest | 12.41% | 4.25% |



*Notes:*

(1) By virtue of CNAHC's 100% interest in China National Aviation Corporation (Group) Limited, CNAHC is deemed to be interested in the 1,380,482,920 foreign shares (excluding H shares) of the Company directly held by China National Aviation Corporation (Group) Limited.

(2) By virtue of John Swire & Sons Limited's 100% interest in John Swire & Sons (H.K.) Limited and their approximately 30% equity interest and 53% voting rights in Swire Pacific Limited, and Swire Pacific Limited's approximately 46% interest in Cathay Pacific, John Swire & Sons Limited, John Swire & Sons (H.K.) Limited and Swire Pacific Limited are deemed to be interested in the 943,321,091 H shares of the Company directly held by Cathay Pacific.

(3) Temasek Holdings (Private) Limited, through its controlled entities, had an attributable interest in 400,450,000 H shares of the Company, out of which the interest in 292,500,000 H shares (representing approximately 9.07% of the total issued H shares) was held directly by Aranda Investment (Mauritius) Pte Ltd. and interest in the remaining 107,950,000 H shares was held directly by Dahlia Investments Ptd Ltd, FPL Alpha Investment Pte Ltd and Fullerton (Private) Limited.

(4) On 18 January 2006, the Company received a notification from HSBC stating that HSBC Halbis Partners (Hong Kong) Limited held 163,840,000 H shares in the Company, which represented 5.08% of the total issued H shares of the Company.

# Report of the Directors

As at 31 December 2005, the interests and short positions of the following persons in the shares and underlying shares of CNAC, as recorded in the register of the Company required to be kept under Section 336 of the SFO were as follows:

| Name of interests holder | Type of interests | Number of relevant ordinary shares of CNAC | Percentage of the total issued share capital of CNAC |
|---|---|---|---|
| CNAHC[(1)] | Attributable interest | 2,264,628,000[(1)] | 68.36% |
| Air China Limited[(2)] | Beneficial owner | 2,264,628,000[(2)] | 68.36% |
| Best Strikes Limited | Beneficial owner | 187,656,000 | 5.66% |
| Novel Credit Limited[(3)] | Attributable interest | 322,856,000[(3)] | 9.75% |
| Novel Enterprises (BVI) Limited[(3)] | Attributable interest | 322,856,000[(3)] | 9.75% |
| Novel Enterprises Limited[(3)] | Attributable interest | 322,856,000[(3)] | 9.75% |
| Novel Holdings (BVI) Limited[(3)] | Attributable interest | 322,856,000[(3)] | 9.75% |
| Novel Investment Holdings Limited[(3)] | Attributable interest | 322,856,000[(3)] | 9.75% |
| On Ling Investments Limited[(3)] | Attributable interest | 322,856,000[(3)] | 9.75% |
| Westleigh Limited[(3)] | Attributable interest | 322,856,000[(3)] | 9.75% |

*Notes:*

(1) CNAHC owns approximately 51.16% of the total issued share capital of the Company and the entire issued share capital of CNACG, a company incorporated in Hong Kong, which in turn owns approximately 14.64% of the total issued share capital of the Company. Accordingly, CNAHC's interests in CNAC duplicate those held by the Company.

(2) CNACG, the former immediate controlling shareholder of CNAC, transferred approximately 69% shareholding interest in CNAC to the Company in September 2004 by way of capital contribution in exchange for the Company's foreign shares (excluding H shares). As such, the Company became the immediate controlling shareholder of CNAC. Accordingly, CNAHC's interests in CNAC duplicate those held by the Company.

(3) 5.6% of the interest held by each of these companies in CNAC duplicates with Best Strikes Limited's interest in CNAC. The interests of these companies in CNAC also duplicate each other.

## PUBLIC FLOAT

Pursuant to public information available to the Company and to the best knowledge of the directors of the Company, at least 25% of the total issued share capital of the Company is held by the public.

# Report of the Directors

## DIVIDEND

The Board recommends the payment of a final dividend of RMB0.2383 per 10 shares for the year ended 31 December 2005, totalling approximately RMB225 million. A resolution for the dividend payment will be submitted for consideration at the annual general meeting to be convened on 12 June 2006. The dividend will be denominated and declared in Renminbi. Dividends on domestic shares will be paid in Renminbi, whereas those on non-H foreign shares and H shares will be paid in Hong Kong dollars. The relevant exchange rate will be the mean of the average rate of Renminbi to Hong Kong dollars as announced by the People's Bank of China for the week prior to the date of declaration of dividends. The final dividends are expected to be paid around 30 June 2006 after its approval by the annual general meeting.

## TAXATION ON DIVIDENDS

Taxes paid by PRC companies are generally PRC withholding tax levied at flat rate of 20%. However, pursuant to the applicable rules of the taxation authority of the PRC, dividends paid by companies in the PRC to shareholders on shares listed on an overseas stock exchange, such as H Shares, are not subject to the abovementioned PRC withholding tax.

## PURCHASES, SALES AND REDEMPTION OF SHARES

During the year ended 31 December 2005, neither the Company nor any of its subsidiaries purchased, sold or redeemed any of the Company's listed securities.



## 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.

# Report of the Directors

## DIRECTORS AND SUPERVISORS OF THE COMPANY

Information of the directors and supervisors of the Company during 2005 and up to the date of this report is as follows:

### Directors

| Name | Age | Position in the Group | Date of appointment as director/supervisor |
|---|---|---|---|
| Li Jiaxiang | 56 | Chairman and non-executive director | 30 September 2004 |
| Kong Dong | 57 | Vice chairman and non-executive director | 30 September 2004 |
| Wang Shixiang | 56 | Vice chairman and non-executive director | 30 September 2004 |
| Yao Weiting | 58 | Non-executive director | 30 September 2004 |
| Ma Xulun | 41 | Executive director and president | 30 September 2004 |
| Cai Jianjiang | 42 | Executive director and vice president | 30 September 2004 |
| Fan Cheng | 50 | Executive director and chief financial officer | 18 October 2004 |
| Hu Hung Lick, Henry | 86 | Independent non-executive director | 22 November 2004 |
| Wu Zhipan | 49 | Independent non-executive director | 30 September 2004 |
| Zhang Ke | 52 | Independent non-executive director | 30 September 2004 |

*Notes:*

(1) Subsequent to his appointment as a director of the Company on 30 May 2005, Mr. David Muir Turnbull resigned as chairman of Cathay Pacific, and then resigned as a director of the Company on 12 December 2005.

(2) On 5 September 2005, the resolution proposed by the Board for the appointment of Mr. Jia Kang as an independent non-executive director of the Company was passed at the annual general meeting held on 28 March 2006. The appointment will come into effect upon the approval from or filing with the relevant authorities in respect of the amendments to the articles of association of the Company regarding the number of directors of the Board.

(3) Cathay Pacific, a shareholder of the Company, nominated Mr. Christopher Dale Pratt as a non-executive director of the Company. After nomination is approved by the Board of the Company it will be proposed for approval by the general meeting of the Company.

### Supervisors

| Name | Age | Position in the Group | Date of appointment as director/supervisor |
|---|---|---|---|
| Zhang Xianlin | 52 | Chairman of Supervisory Committee | 30 September 2004 |
| Liao Wei | 41 | Supervisor | 18 October 2004 |
| Zhang Huilan | 45 | Supervisor | 30 September 2004 |
| Liu Feng | 47 | Supervisor | 30 September 2004 |
| Liu Guo Qing | 44 | Supervisor | 23 August 2005 |

## INDEPENDENCE OF THE INDEPENDENT NON-EXECUTIVE DIRECTORS

The Company has confirmed its receipt of, from each of the independent non-executive directors of the Company, a confirmation of his independence pursuant to Rule 3.13 of the Listing Rules. The Company considers all of the independent non-executive directors to be independent.

# Report of the Directors

## BOARD COMMITTEES

The Board committees include the strategy and investment committee, audit and risk control committee and nomination and remuneration committee. The composition of each committee is set out in the "Corporate Governance Report" in this annual report.

## DIRECTORS' AND SUPERVISORS' INTERESTS AND SHORT POSITIONS IN THE SHARES, UNDERLYING SHARES AND DEBENTURES OF THE COMPANY

As at 31 December 2005, Mr. Zhang Xianlin, a supervisor of the Company, had interests in 33,126,000 shares, which represented 1% of the share capital of CNAC, a subsidiary of the Company. Save as mentioned above, none of our directors, supervisors and chief executives had any interests or short positions in the shares, underlying shares or debentures of the Company or its any associated corporations (within the meaning of Part XV of the SFO), as recorded in the register required to be kept under section 352 of the SFO or as notified to the Company and the Stock Exchange pursuant to the Model Code for Securities Transactions by Directors of Listed Companies.

## REMUNERATION OF DIRECTORS AND SUPERVISORS

Details of the remuneration of directors and supervisors are set out in note 10 to the financial statements for the year.

## INTERESTS OF DIRECTORS AND SUPERVISORS IN CONTRACTS AND SERVICE CONTRACTS



Each of the Directors has entered into a service contract with the Company for a term of three years from 30 September 2004 other than Mr. Fan Cheng, whose service contract has a term of three years from 18 October 2004, and the service contract is thereafter subject to termination by either party giving written notice to the other party.

None of the Directors has any existing or proposed service contract with any member of the Group which is not expiring or terminable by the Group within one year without payment of compensation (other than statutory compensation).

Apart from the service contract entered into between the Company and its subsidiaries (if applicable), in the year ended 31 December 2005, none of the directors and supervisors of the Company was materially interested, whether directly or indirectly, in any contract of significance to which the Company, its subsidiary or holding company or a subsidiary of the Company's holding company is a party.

## CONVENTION OF BOARD MEETINGS AND COMPLIANCE WITH THE CODE OF BEST PRACTICE

The Company held eight Board meetings during the year. The Company has been improving its corporate governance structure since listing. The Board is committed to conducting normative operations to protect the interests of the Company and its shareholders.

The directors of the Company are of the opinion that the Company has complied with the requirements set out in the revised Code on Corporate Governance Practices (the "Code") contained in Appendix 14 to the Listing Rules to revise the internal governance structure of the Company.

# Report of the Directors

## EMPLOYEES

As at 31 December 2005, the Group had 18,447 employees and its subsidiaries and associated companies had 12,145 employees. The following table sets forth the numbers and percentages of employees in different departments of the Company:

| Employees | Number | Percentage of total (%) |
|---|---|---|
| **Flight crew** | **5,066** | **27.5** |
| Pilots | 2,492 | 13.5 |
| Flight attendants | 2,574 | 14.0 |
| **Ground crew** | **13,381** | **72.5** |
| Ground services | 2,669 | 14.5 |
| Maintenance | 3,297 | 17.9 |
| Others | 2,098 | 11.4 |
| Marketing and sales | 2,101 | 11.4 |
| Management | 3,216 | 17.4 |
| **Total** | **18,447** | **100** |

## COMPENSATION POLICY



Employees of the Company receive cash remuneration consisting of salary and other cash subsidies. In general, employees' salaries are determined based on the employees' qualification, position, seniority and performance. Cash subsidies to employees include living subsidies and are subject to changes. The Company also provides various non-cash benefits, including medical insurance, unemployment insurance, early retirement and other social welfare benefits. In addition, all of our full-time employees in the PRC are covered by a defined contribution retirement scheme operated by the PRC government, to which the Company is required to make annual contributions at rates ranging from 15% to 20% of our employees' basic salaries.

In 2005, thanks to the effort of our staff as a whole, the Company maintained good performance. To enhance staff productivity and the Company's competitive strengths, the Company adjusted staff salary on the basis of RMB300 per month on average in the second half of the year, thereby incurring an expense of approximately RMB62 million for the whole year.

In addition, in order to provide incentives to the flight crew, the Board of the Company approved the Proposal on the Reform of Remuneration and Benefits System for the Flight Crew (飛行人員薪酬福利制度改革方案) on 30 December 2005, which came into effect on 1 March 2006.

## EMPLOYEES AND EMPLOYEES' PENSION SCHEME

All employees of the Company are covered by a defined contribution retirement scheme operated by the PRC government, to which the Company is required to make annual pension contributions to the government at rates ranging from 15% to 20% of the aggregate salary of all our staff.

145 employees of the Company retired in 2005. These retired employees are entitled to benefits under the social pension scheme approved and provided by the labour and social security authority of the local government. Details of the staff pension scheme and other welfare are set out in note 11 to the financial statements.

# Report of the Directors

## SHARE APPRECIATION RIGHTS

The Share Appreciation Rights Scheme of the Company has been approved by the State-owned Assets Supervision and Administration Commission ("SASAC") under the State Council of the PRC. The implementation measures of the Share Appreciation Rights Scheme will come into effect upon approval by the Board and filing with the SASAC. Details of the Share Appreciation Rights Scheme are set out in note 39 to the financial statements for 2005.

## SUBSIDIARIES AND ASSOCIATED COMPANIES

As at 31 December 2005, details of the subsidiaries and associated companies of the Company are set out respectively in notes 18 and 19 to the financial statements for 2005.

## USE OF PROCEEDS FROM INITIAL PUBLIC OFFERING

The net proceeds from its the global initial public offering of H shares of the Company amounted to HK$8,246,014,864. As stated in the prospectus of the Company, it is intended that approximately RMB4.8 billion of the proceeds will be used to acquire ten Airbus 319 aircraft and four Boeing 737-700 aircraft, and the remaining balance estimated to be approximately RMB3.97 billion will be used to repay liabilities falling due within one year and to supplement our cash flow.

As of 31 December 2005, the Company settled the payment of approximately RMB4,283,256,876 for acquiring ten Airbus 319 aircraft and four Boeing 737-700 aircraft in accordance with the proposed use of proceeds set out in the prospectus, saving the Company approximately RMB516,743,124 compared to the estimated RMB4.8 billion disclosed in the prospectus. The surplus amount have been used to repay liabilities falling due within one year and to supplement our cash flow in accordance with proposed use of proceeds set out in the prospectus. As such, all proceeds from the H share offering have been used up.



The Board of the Company considers that the use of proceeds by the Company conformed to the undertakings set out in the prospectus and the relevant projects were completed as scheduled with satisfactory capital efficiency.

## BANK AND OTHER BORROWINGS

Details of bank and other borrowings of the Company and the Group are set out in note 33 to the financial statements.

## FIXED ASSETS

Movements in fixed assets of the Group for the year ended 31 December 2005 are set out in note 15 to the financial statements for 2005.

## INTERESTS CAPITALISED

Details of interests capitalised of the Group for the year ended 31 December 2005 are set out in note 8 to the financial statements for 2005.

## RESERVES

Movements in the reserves of the Company and the Group during the year are set out in note 38 to the financial statements and consolidated statement of changes in equity.

# Report of the Directors

## CHANGES IN EQUITY

Please refer to the consolidated statement of changes in equity.

## DONATIONS

For the year ended 31 December 2005, the Company made donations for charitable and other purposes amounting to RMB42.71 million.

## PROPERTY TITLE CERTIFICATE

The Company effected changes of titles of assets, e.g. land, real estates and vehicles, in accordance with its undertakings in the prospectus of H shares offering. To date, the transfer procedures for motor vehicles of the Company's headquarter and branch companies have been substantially completed. The title transfer procedures for land and real estates of the Company's headquarter and branch companies have also been substantially completed save for a few regions. At present the unfinished work is still in progress, which do not have material adverse effect on the operation of the Company.

## MAJOR CUSTOMERS AND SUPPLIERS

For the year ended 31 December 2005, the purchases from the largest equipment supplier accounted for 18.09% of the total purchases of the Group, while purchases from the five largest equipment suppliers accounted for 48%. None of the directors or supervisors of the Company, their associates, nor any shareholder, who to the knowledge of the directors own 5% or more of the Company's share capital, had any interest in the five largest equipment suppliers of the Company.



For the year ended 31 December 2005, the sales of the Group to the five largest customers accounted for not more than 30% of the total sales of the Group.

## MATERIAL LEGAL PROCEEDINGS

As of 31 December 2005, the Group was not involved in any significant litigation or arbitration save for those disclosed in note 41 to the financial statements. To the knowledge of the Group, there was no litigation or claim of material importance pending or threatening or initiated against the Company.

## CONNECTED TRANSACTIONS

The Group has entered into a number of transactions on a continuing basis with CNAHC and its associated companies (as defined under the Listing Rules) and other connected persons of the Group. Details of those connected transactions conducted in 2005, which are not exempt under Rule 14A.33 of the Listing Rules, are as follows:

### I. Continuing Connected Transactions Between Our Group and CNAHC Group

*Trademark Licensing*

Pursuant to a trademark licence agreement (the "Trademark Licence Agreement") entered into between the Company and CNAHC on 1 November 2004, and subject to the Non-competition Agreement between the two parties, the Company granted to CNAHC and its wholly-owned or controlled subsidiaries a licence to use 17 registered trademarks which the Company held in connection with the business operations of CNAHC and its wholly-owned or controlled subsidiaries but not related to the core businesses of the Company on a royalty-free basis. The Company reserves the right to use or license any independent third party to use the above trademarks, or to transfer the trademarks to any independent third party provided that the interest of the existing licensee is not prejudiced. The term of the agreement shall commence on the date of incorporation of the Company and end on 31 December 2014.

# Report of the Directors

On 28 March 2006, the Company and CNAHC entered into a Trademark Licence Supplementary Agreement, whereby the Company granted to CNAHC a licence to use trademark no. 1125894 in connection with the business operations of CNAHC and its wholly-owned or controlled subsidiaries on a royalty-free basis and on the same terms and conditions as the Trademark Licence Agreement. As such, the total number of registered trademarks licenced by the Company to CNAHC and its wholly-owned or controlled subsidiaries amounted to 18.

*Construction Project Management Services*

The Company entered into a construction project management agreement (the "Construction Project Management Agreement") with China National Aviation Construction and Development Company ("CNACD"), a wholly-owned subsidiary of CNAHC on 1 November 2004.

Pursuant to this agreement:

- CNACD will provide the Company project management services on projects involving the construction of any property or industrial plant/facility with budgeted costs of RMB20 million or above;

- in return for its project management services, the Company pay CNACD a fee of up to 2% of the construction budget if the budget is RMB1 billion or more, and up to 2.5% if the budget is below RMB1 billion;

- if CNACD is able to manage the construction projects such that the final cost falls below the budgeted amount anticipated by the Company, the Company will pay CNACD a bonus of an amount to be determined by both parties through arm's length negotiation but shall not exceed 40% of the management fee calculated on the basis of the budgeted amount of the relevant project;

- if the final cost of the project managed by CNACD is higher than the budgeted amount, CNACD will pay the Company the difference between the final cost and the budgeted amount, unless the difference is caused by (i) a change of government policies; (ii) factors attributed to the Company; or (iii) force majeure; and

- If CNACD acquires land relating to a project on the Company's behalf, the Company will pay CNACD an agency fee of up to 2% of all the fees and expenses in relation to the land acquisition (including, among other things, land acquisition fee, formality fee, labour expenses and travelling expenses, but excluding land premium).

The Construction Project Management Agreement will expire on 31 December 2006, subject to renewal.

*Properties Leasing*

The Company entered into a properties leasing framework agreement (the "Properties Leasing Framework Agreement") with CNAHC on 1 November 2004.

Pursuant to this agreement, the Company will lease from CNAHC 14 properties with an aggregate gross floor area of approximately 53,087 sq. m. for various uses, including as business premises, offices and storage facilities. The Company will also lease to CNAHC 7 properties with an aggregate gross floor area of approximately 8,262 sq. m. The rents payable under the Properties Leasing Framework Agreement are and will continue to be determined in accordance with market rates.

The Properties Leasing Framework Agreement will expire on 31 December 2006 subject to renewal.

# Report of the Directors

*Media and Advertising Services*

The Company entered into a media and advertising services framework agreement (the "Advertising Services Framework Agreement") on 1 November 2004 with China National Aviation Media and Advertisement Co., Ltd. ("CNAMC"), a wholly-owned subsidiary of CNAHC.

Pursuant to this agreement, CNAMC will have the right to procure advertisements and to retain all advertising revenues generated from such advertisements that appear:

- in the in-flight magazines, in-flight entertainment programmes, boarding passes and certain other items specified in the Advertising Services Framework Agreement (the "Specified Items"); and
- on the potential items that may be developed from time to time (the "Potential Items").

As a consideration, CNAMC will pay the Company an annual concession fee for the Specified Items and 20% of the total revenues generated from advertisements appearing on the Potential Items. CNAMC has also agreed to:

- provide the Company at nil charge the in-flight items (except for in-flight entertainment programmes) and the Potential Items (for those not owned by the Company) on which the advertisements appear or will appear;
- provide the Company with some in-flight entertainment programmes produced by it, the production cost and expense of which will be reimbursed by the Company; and
- procure contents for the Company's in-flight entertainment programmes from independent third parties on a commission-free basis.

In addition, CNAMC has the right to bid for advertisement agency and design services to the Company.

The Advertising Services Framework Agreement will expire on 31 December 2006 subject to renewal.

*Tourism Co-operation Services*

The Company entered into a tourism services cooperation agreement (the "Tourism Cooperation Agreement") on 1 November 2004 with China National Aviation Tourism Company ("CNATC").

Pursuant to this agreement, the Company has agreed to provide the following services to CNATC:

- Commercial charter flight services: the Company will provide charter services to customers procured by CNATC at market rates.
- Package tours co-operation services: the Company and CNATC will sell package tours combining (i) the Company's airline tickets with (ii) accommodation at hotels owned and operated by CNATC. For the airline tickets in such packages sold by CNATC, CNATC will pay the Company in accordance with the pricing principle under the "Sales Agency Framework Agreement" while the Company will pay CNATC for the hotel fee portion of the packages.
- Reciprocal frequent-flyer programme ("FFP") co-operation services: CNATC will join the Company's FFP under which our Companion card members are encouraged to stay at CNATC's hotels by receiving mileage credits for such stay. As consideration, CNATC will pay us the equivalent value represented by those mileage credits.

# Report of the Directors

Pursuant to the Tourism Cooperation Agreement, CNATC agreed to provide the following services to the Company:

- FFP co-operation services: Under the FFP, if our Companion card members redeem their mileage credits for free, discounted or upgraded stay at CNATC's hotels, the Company will reimburse CNATC for such redemption at a price similar to our arrangements with other FFP partners.

- Hotel accommodation services: CNATC will provide hotel accommodation services to the Company's employees on duty and passengers affected by our flight delays or cancellations, for which services the Company will pay relevant fees to CNATC at group rates.

The Tourism Co-operation Agreement will expire on 31 December 2006 subject to renewal.

*Comprehensive Services*

The Company entered into a comprehensive services agreement (the "Comprehensive Services Agreement") with CNAHC on 1 November 2004 pursuant to which:

- CNAHC will provide the Company with various ancillary services, including but not limited to:

  (i) supply of various items for in-flight services;

  (ii) manufacturing and repair of airline-related ground equipment and vehicles;

  (iii) cabin decoration and equipment;

  (iv) passenger cabin and cargo cabin ancillary parts (including seats);

  (v) warehousing services;

  (vi) cabin cleaning services; and

  (vii) printing of air tickets and other documents.

- The Company will provide certain welfare-logistics services to the retired employees of CNAHC and its subsidiaries.

The charges payable by the Company to CNAHC for the comprehensive services above, as well as the charges payable by CNAHC to the Company for the welfare-logistics services provided to its retired employees, shall be based on prevailing market rate or, if no prevailing market rate is available, fair and reasonable price determined after arm's length negotiation.

The Comprehensive Services Agreement will expire on 31 December 2006 subject to renewal.

*Line Maintenance and Other Ground Services*

The Company entered into a standard ground handling agreement (the "Standard Ground Handling Agreement") with China Aircraft Services Limited ("CASL"), a 40%-owned subsidiary of CNACG, on 17 April 2004, pursuant to which CASL would provide line maintenance and other ground services to the Company at the Hong Kong International Airport. The services are charged at market rates.

# Report of the Directors

*Financial Services*

On 1 November 2004, The Company entered into a financial services agreement (the "Financial Services Agreement") with China National Aviation Finance Co., Ltd. ("CNAF") which is owned as to 74.89% by CNAHC and 19.31% by the Company as of 31 December 2005.

Pursuant to this agreement, CNAF has agreed to provide the Company a range of financial services including the following:

- deposit services;
- loan and finance leasing services;
- negotiable instrument and letter of credit services;
- trust loan and trust investment services;
- underwriting services for debt issuances;
- intermediary and consulting services;
- guarantee services;
- settlement services;
- internet banking services; and
- any other services provided by CNAF under the approval of the China Banking Regulatory Commission ("CBRC").

The fees and charges payable by the Company to CNAF under the Financial Services Agreement are determined with reference to the applicable fees and charges specified by the People's Bank of China (the "PBOC") and the CBRC for the relevant services from time to time, and if neither the PBOC nor the CBRC has specified a fee or charge for a particular service, then the service will be provided by CNAF on terms no less favourable than terms available from commercial banks in China.

The Financial Services Agreement will expire on 31 December 2006 subject to renewal.

*Subcontracting of Charter Flight Services*

The Company entered into a charter flight service framework agreement (the "Charter Flight Service Framework Agreement") on 1 November 2004 with CNAHC.

Pursuant to this agreement, CNAHC will subcontract to the Company its obligation of government charter flight that it undertakes from the PRC government. The Company's hourly rate of the charter flight service fee will, subject to periodical adjustment, be calculated on the basis of the following formula which includes total cost and reasonable margins:

Hourly rate = Total cost per flight hour x (1 + 6.5%)

Total cost includes all direct costs and indirect costs.

The Charter Flight Service Framework Agreement will expire on 31 December 2006 subject to renewal.

# Report of the Directors

*Sales Agency Services for Airline Tickets and Cargo Space*

The Company entered into a sales agency framework agreement with CNAHC (the "Sales Agency Services Framework Agreement") on 1 November 2004.

Pursuant to this agreement, certain associates of CNAHC acting as the Company's sales agents will:

- purchase air tickets and cargo spaces from the Company at wholesale prices and resell such air tickets and cargo spaces to end-purchasers; or

- procure purchasers for the Company's air tickets and cargo spaces on a commission basis.

The Company will pay the relevant agency commission based on relevant PRC regulations or, where the regulations do not provide for a specific commission, based on market rates. Currently, the commissions prescribed for sales of air tickets are as follows:

- for domestic routes, 3% of the ticket price;

- for Hong Kong and Macau routes, 7% of the ticket price; and

- for international routes, 9% of the ticket price.

In accordance with industry practice, and subject to applicable regulations, the Company may also offer incentives to sales agents for reaching certain ticket sale targets.



The Sales Agency Services Framework Agreement will expire on 31 December 2006 subject to renewal.

## II. Continuing Connected Transactions between the Group and the Lufthansa Group

Lufthansa holds 40% equity interest in and is a substantial shareholder of Aircraft Maintenance and Engineering Corporation ("Ameco"), a subsidiary of the Company, and is therefore a connected person of the Company under the Listing Rules.

The Company has entered into various transactions with Lufthansa and its associates (collectively, the "Lufthansa Group") in the ordinary course of its business, including, among others:

- Aircraft maintenance, repair and overhaul services ("MRO Services") provided by the Company to the Lufthansa Group;

- mutual provision of catering services;

- mutual provision of ground handling services in China and Germany;

- mutual provision of ticket sales agency services;

- airline codeshare arrangement under which the actual carrier's flights can be marketed under the airline designator code of the partner carrier and revenues earned from these arrangements are allocated between the parties based on negotiated terms according to airline industry standards;

# Report of the Directors

- special prorate arrangement under which a carrier agrees to accept passengers from another carrier and receive payment directly from that carrier; and

- other airline co-operation arrangements between the Lufthansa Group and the Company.

The above transactions have been entered into on normal commercial terms based on arm's length negotiations.

## III. Continuing Connected Transactions between the Group and the Beijing Capital Airports Group

Capital Airports Holding Company holds 24% equity interest in and is a substantial shareholder of Air China Cargo, and therefore is a connected person of the Company under the Listing Rules. The Company has entered into various transactions with Capital Airports Holding Company and its associates (collectively, the "Beijing Capital Airports Group") in the ordinary course of its business, including, among others:

- provision of taking-off/landing/parking services of the Company's aircraft at airports owned by the Beijing Capital Airports Group;

- provision of passengers' waiting lounge, check-in counters and office buildings to the Company by airports owned by the Beijing Capital Airports Group;

- provision of utilities (including water, gas and electricity) to the Company at Beijing Capital International Airport by the Beijing Capital Airports Group; and

- provision of ground handling services to the Company by the Beijing Capital Airports Group.



Most of the services provided by the Beijing Capital Airports Group to the Company are charged on the pricing terms which are prescribed, approved or recommended by PRC governmental authorities.

## IV. Continuing Connected Transactions between the Group and the Cathay Pacific Group

Cathay Pacific holds 10% of the total issued share capital of the Company and therefore is a connected person of the Company under the Listing Rules. The Company has entered into various transactions with Cathay Pacific and its associates (collectively, the "Cathay Pacific Group") in the ordinary course of its business. Such transactions, which constitute an essential part of the daily operations of an airline business, include, among others:

- provision of ground handling services by the Cathay Pacific Group to the Company;

- provision of MRO Services by the Company to the Cathay Pacific Group;

- provision of catering services by the Company to the Cathay Pacific Group; and

- mutual provision of ticket sales agency services.

The above transactions have been entered into on normal commercial terms based on arm's length negotiations.

# Report of the Directors

## V. Continuing Connected Transactions between the CNAC Group and Other Connected Persons of the Group

CNAC is a non-wholly owned subsidiary of the Company. Therefore, the continuing connected transactions entered into between CNAC and its subsidiaries (collectively, the "CNAC Group") as one party and connected persons as the other party, will also constitute continuing connected transactions for the purpose of the Group under the Listing Rules. Details of such continuing connected transactions conducted in 2005, which the Company considered would not be exempted under Rule 14A.33 of the Listing Rules, are as follows:

*Provision of In-flight Catering Services by Macau Catering Services Company Limited*

For in-flight meals to its passengers, Air Macau entered into a Catering Services Agreement on 1 November 2001 with Macau Catering Services Company Limited ("MCS"). Pursuant to the Catering Services Agreement, Air Macau purchased meals from MCS, an associate of Sociedade de Turismo e Diversoes de Macau ("STDM"). Since STDM has 14% equity interest in Air Macau and MCS is an associate of STDM, MCS is a connected person of CNAC and therefore a connected person of the Company. Since MCS is the only provider of in-flight meals in Macau, Air Macau continued to purchase in-flight meals from MCS pursuant to the Agreement on normal commercial terms determined on an arm's length basis. The Catering Services Agreement will remain valid until 31 October 2006 unless otherwise terminated according to its terms and conditions.

The Board has considered and proposed that the annual cap for the values of the transactions contemplated under the Catering Services Agreement for each of the three years ending 31 December 2005, 2006 and 2007 shall be HK$65 million, HK$75 million and HK$95 million, respectively. The amount paid by Air Macau to MCS in respect of the provision of the catering services in 2005 was HK$51.49 million. For this purpose, the percentage ratio calculated according to the Listing Rules is less than 2.5% but more than 0.1%. Accordingly, for the purpose of the Company, such transactions are exempt from independent shareholders' approval requirement but are subject to the announcement requirement for connected transactions under the Listing Rules. CNAC has obtained a waiver from the Stock Exchange from strict compliance with the announcement and/or independent shareholders' approval requirements under the Listing Rules in relation to the above continuing connected transactions.



*Payment of Airport Charges and Airport Fees*

In the ordinary course of business of Air Macau, airport charges and airport fees are invoiced and collected by Administration of Airports Limited ("ADA"), an indirect subsidiary of CNACG, on behalf of Macau International Airport Company ("MIAC"), an associated company of a substantial shareholder of Air Macau. As a result, the payment of airport charges and airport fees constitutes continuing connected transactions under the Listing Rules.

On 17 March 2006, Air Macau and ADA, being the authorized agent responsible for the global management and provision of operational services to MIAC, including the collection of Airport Charges, entered into a legally binding acknowledgement pursuant to which it was acknowledged by Air Macau and ADA that certain facilities and services are provided by MIAC to Air Macau.

In respect of Air Macau's operation at the Macau International Airport, Air Macau entered into the Airport License on 9 September 2004 and the Proposed Airport License with MIAC with a term of one year (which will be automatically renewed for another year unless it is terminated by either party by way of 90 days prior written notice) and one year respectively. The current term of the Airport License will expire on 7 September 2006 and the term of the Proposed Airport License will expire on 28 February 2007. Pursuant to the Airport License and the Proposed Airport License, MIAC licensed certain floor space (including ticketing and check-in counters, operation/traffic service offices, and lounges) at the Macau International Airport to Air Macau.

The total airport charges and airport fees paid by Air Macau to ADA in 2005 was approximately HK$86.34 million. For this purpose, the percentage ratio calculated according to the Listing Rules is less than 2.5% but more than 0.1%. Accordingly, for the purpose of the Company, such transactions are exempt from independent shareholders' approval requirement but are subject to the announcement requirement for connected transactions under the Listing Rules. CNAC has obtained a waiver from the Stock Exchange from strict compliance with the announcement and/or independent shareholders' approval requirements under the Listing Rules in relation to the above continuing connected transactions.

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## VI. Waiver from Strict Compliance of the Listing Rules

The Company has obtained a waiver from the Stock Exchange expiring on 31 December 2006 from strict compliance with the announcement and/or independent shareholders' approval requirements under the Listing Rules in relation to the above continuing connected transactions (except for transactions set out under section V above). The maximum aggregate annual value ("cap") permitted by the Stock Exchange and the aggregate annual value actually occurred for each of the above continuing connected transactions for the year ended 31 December 2005 are set out below:

| Transactions | Aggregate Amount of Transactions for the Year Ended 31 December 2005 | |
|---|---|---|
| | Cap<br>*RMB (in millions)* | Actual Amount<br>*RMB (in millions)* |
| **Transactions with the CNAHC Group** | | |
| Construction project management services | **40.0** | **1.18** |
| Properties leasing | **50.0** | **29.89** |
| Media and advertising services | **24.7** | **18.70** |
| Tourism services co-operation | **35.6** | **16.16** |
| Comprehensive services | **115.0** | **91.20** |
| Line maintenance and other ground services | **45.0** | **29.15** |
| Financial services: | | |
| Payment of fees and charges | **40.0** | **14.40** |
| Maximum daily outstanding deposits with CNAF | **5,000.0** | **1047.08** |
| Maximum daily outstanding loans from CNAF | **3,000.0** | **597.47** |
| Subcontracting of charter flights | **650.0** | **407.05** |
| Sales agency service: | | |
| Aggregate sales of airline tickets and cargo space to the CNAHC Group for resale to end purchasers | **470.0** | **232.83** |
| Aggregate ticket and cargo agency commission and amount of incentives to be paid by the Company to CNAHC Group | **35.0** | **34.74** |
| **Transactions with the Lufthansa Group** | | |
| Total amount to be paid by the Company to the Lufthansa Group | **660.0** | **634.34** |
| Total amount to be paid by the Lufthansa Group to the Company | **530.0** | **466.27** |
| **Transactions with the Beijing Capital Airports Group** | | |
| Total amount to be paid by the Company to the Beijing Capital Airports Group | **900.0** | **709.82** |
| **Transactions with the Cathay Pacific Group** | | |
| Aggregate amount to be paid by the Company to the Cathay Pacific Group | **40.0** | **20.14** |

# Report of the Directors

### VII. Confirmation from Independent Non-executive Directors

The independent non-executive directors of the Company have confirmed that all connected transactions in the year ended 31 December 2005 to which the Company was a party have been entered into:

1. in the ordinary and usual course of business of the Company;

2. either:

   (i) on normal commercial terms; or

   (ii) where there was no comparable transactions to judge whether they were on normal commercial terms, on terms no less favourable to the Company than terms available to or from independent third parties, where applicable; and

3. in accordance with terms that were fair and reasonable and in the interests of the shareholders of the Company as a whole.

### VIII. Confirmation from the Auditors

Ernst & Young, the auditors of the Company, has confirmed by a letter to the Board that the above connected transactions:



1. have been approved by the Board;

2. were in line with the pricing policies as set out in the relevant agreements;

3. have been entered into in accordance with the relevant agreement governing the transactions; and

4. did not exceed the cap disclosed in the prospectus of the Company.

## CONTRACT OF SIGNIFICANCE

None of the Company or any of its subsidiaries entered into any contract of significance with the controlling shareholder or any of its subsidiaries. There is no contract of significance in relation to provision of services by the controlling shareholder or any of its subsidiaries to the Company or any of its subsidiaries. None of the shareholders entered into any arrangement to waive or agree to waive any dividend.

## AUDITORS

The Company appointed Ernst & Young and Ernst & Young Hua Ming as its international auditors and domestic auditors respectively for the year ended 31 December 2005. Ernst & Young has audited the attached financial statements prepared in accordance with the International Financial Reporting Standards. The Company has retained Ernst & Young and Ernst & Young Hua Ming since the date of its listing. A resolution in respect of the reappointment of Ernst & Young and Ernst & Young Hua Ming as the Company's international and domestic auditors respectively for the year ending 31 December 2006 will be proposed at the Annual General Meeting of the Company to be held on 12 June 2006.

By Order of the Board
**Li Jiaxiang**
*Chairman*

Beijing, PRC
18 April 2006