



Review of Operations
and Management's
Discussion and Analysis



Luo Chaogeng, President

A large, stylized handwritten signature in black ink, written in Chinese characters. The signature is positioned to the right of the portrait and above the main text block.

In 2005, we operated a total of 380 routes, of which 273 were domestic routes (including 16 routes to Hong Kong) and 107 were international routes (including 30 international cargo routes). We operated approximately 4,860 scheduled flights per week, serving a total of 118 foreign and domestic cities. In 2005, as part of our acquisition of certain assets and liabilities relating to the aviation businesses of China Eastern Air Northwest Company ("CEA Northwest") and China Eastern Air Yunnan Company ("CEA Yunnan"), we acquired or assumed the ownership of or the leases for 60 additional aircraft, 50 of which we continued to operate as of December 31, 2005. We also added 27 aircraft to our

fleet through other transactions, including the purchase of two Airbus A321 aircraft and three ERJ145 aircraft, the finance lease of five Airbus A320 aircraft, the operating lease of four Airbus A320 aircraft, seven B737-700 aircraft and three B737-800 aircraft, and the wet lease of one Airbus A300F freighter and two B747F freighters. As of December 31, 2005, we operated a fleet of 180 aircraft, including 162 passenger jets each with a seating capacity of over 100 seats and 10 jet freighters.

Review of Operations and Management's Discussion and Analysis

The following table sets forth details of our operating fleet as of December 31, 2005:

	As of December 31, 2005			Planned Additions*	
	Number of Aircraft Owned and under Finance Leases	Number of Aircraft under Operating Leases	Total Number of Aircraft	2006	2007
A340-600	5		5		
A340-300	5		5		
A330-300				7	5
A330-200				3	1
A300-600	10	3	13		
A310	3		3		
A321	4		4	2	4
A320	37	26	63		2
A319		10	10	3	2
MD-90	9		9		
MD-82		3	3		
B737NG					2
B737-800		3	3		
B737-700	8	14	22	7	
B737-300	13	6	19		
B767-300	3		3		
ERJ145	3		3	4	3
CRJ-200	5		5		
A300F		2	2		
B747F		2	2	1	1
MD-11F	6		6		
Total	111	69	180	27	20

* Except for three Airbus A330-200 aircraft and two Airbus A330-300 aircraft to be acquired under operating leases and five Airbus A330-300 to be acquired by means to be determined, other aircraft will be owned or acquired under finance leases.

Review of Operating Results

The following discussion and analysis should be read together with our audited financial statements and the accompanying notes prepared in accordance with IFRS that are included elsewhere in this annual report. The financial data presented in this section are derived from our audited financial statements prepared in accordance with IFRS.

Revenues. Our revenues increased 28.4% from RMB21,387 million in 2004 to RMB27,454 million in 2005 (net of the applicable PRC business tax). This increase was primarily due to an increase in our capacity resulting from our acquisition of the assets and liabilities relating to the aviation businesses of CEA Northwest and CEA Yunnan and our acquisition of other aircraft.

Traffic revenues increased 29.3% from RMB19,962 million in 2004 to RMB25,820 million in 2005. Compared to 2004, the average aircraft daily utilization rate decreased by 0.3 hours to 9.4 hours in 2005 partially due to a decrease in the aircraft daily utilization rate of certain older aircraft.

Passenger revenues, which accounted for 80.8% of our total traffic revenues in 2005, increased 34.2% from RMB15,534 million in 2004 to RMB20,853 million in 2005 primarily due to the expansion of our operations.

Our domestic passenger revenues (excluding Hong Kong passenger revenues), which accounted for 54.9% of our total passenger revenues in 2005, increased 38.1% from RMB8,284 million in 2004 to RMB11,439 million in 2005. This increase was primarily due to an increase of our domestic passenger traffic following increases in our capacity and in our domestic passenger load factor. Compared to 2004, our domestic passenger traffic increased (as measured in revenue passenger-kilometers, or RPKs) by 39.9% in 2005. As a result of the completion of our acquisition of certain assets and liabilities relating to the aviation businesses of CEA Northwest and CEA Yunnan in the second half of 2005 and our acquisition of other aircraft in 2005, the capacity of our domestic routes increased by 33.1% in 2005. Our domestic passenger load factor increased from 70.3% in 2004 to 73.8% in 2005 primarily due to an increase in market demands. Our domestic passenger yield decreased from RMB0.57 in 2004 to RMB0.56 in 2005 per passenger-kilometer primarily as a result of the escalating pricing competition in the domestic traffic market.

Hong Kong passenger revenues, which accounted for 12.0% of our total passenger revenues in 2005, increased 11.4% from RMB2,240 million in 2004 to RMB2,495 million



in 2005. This increase was primarily due to an increase in our Hong Kong passenger traffic resulting from an increase of our capacity. An increase in the passenger yield on Hong Kong routes also contributed to the increase of our Hong Kong passenger revenues. Hong Kong passenger traffic (as measured in RPKs) increased by 8.1% in 2005, compared to 2004. We increased the passenger capacity on our Hong Kong routes by 8.9% in 2005. Our Hong Kong passenger load factor decreased from 62.6% in 2004 to 62.1% in 2005 primarily due to intensified competition. Our Hong Kong passenger yield increased from RMB0.74 in 2004 to RMB0.76 in 2005 per passenger-kilometer, reflecting increases in air fares.

International passenger revenues, which accounted for 33.2% of our total passenger revenues in 2005, increased 38.1% from RMB5,010 million in 2004 to RMB6,920 million in 2005. This increase was primarily due to an increase in our international passenger traffic resulting from increases in our capacity and in our international passenger load factor. An increase of our international passenger yield also contributed to the increase of our international passenger revenues. Our International passenger traffic (as measured in RPKs) increased by 27.6% in 2005, compared to 2004. Our international passenger capacity increased by 22.1% in 2005, compared to 2004. Our international passenger

load factor increased from 62.4% in 2004 to 65.2% in 2005. Our international passenger yield increased from RMB0.50 in 2004 to RMB0.54 in 2005 per passenger-kilometer, reflecting increases in air fares.

We generate cargo and mail revenues from the transportation of cargo and mail on our designated cargo aircraft as well as from the carriage of cargo and mail on our passenger aircraft. Revenues from cargo and mail operations, which accounted for 19.2% of our total traffic revenues in 2005, increased 12.2% from RMB4,428 million in 2004 to RMB4,967 million in 2005 primarily due to an increase in our cargo and mail traffic following an increase in our capacity. Our cargo and mail traffic (as measured in revenue freight tonne-kilometers, or RFTKs) increased 14.8% from 1,875 million RFTKs in 2004 to 2,152 million RFTKs in 2005. Our cargo and mail capacity (as measure in available freight tonne-kilometers, or AFTKs) increased 21.2% from 3,327 million AFTKs in 2004 to 4,033 million AFTKs in 2005. Cargo yield decreased from RMB2.36 in 2004 to RMB2.31 in 2005 per cargo tonne-kilometer primarily due to fare decreases resulting from intensified market competition.

Our other revenues are primarily generated from airport ground services and ticket handling services. Airport ground services include loading and unloading of aircraft, aircraft

cleaning and ground transportation of cargo and passenger luggage for airlines flying to or from Hong Qiao International Airport and Pudong International Airport. We are currently the principal provider of airport ground services at both Hong Qiao International Airport and Pudong International Airport. Our other revenues increased 14.7% from RMB1,424 million in 2004 to RMB1,634 million in 2005 primarily due to the increased revenue from our airport ground services and other services from RMB692 million and RMB95 million, respectively, in 2004 to RMB795 million, and RMB189 million, respectively, in 2005.

Operating Expenses. Our total operating expenses increased 36.8% from RMB20,239 million in 2004 to RMB27,685 million in 2005 primarily due to our business expansion and a significant increase in aviation fuel expenses resulting from increased fuel prices. Our total operating expenses as a percentage of our revenues increased from 94.6% in 2004 to 100.8% in 2005.

Aviation fuel expenses increased 63.7% from RMB5,430 million in 2004 to RMB8,889 million in 2005. This increase was primarily a result of rising fuel prices and our business expansion in 2005. In 2005, we consumed a total of 1,893,700 tonnes of aviation fuel, representing an increase of 30.2% compared to 2004. Compared to 2004, the weighted average domestic and international fuel prices paid by our company in 2005 increased by approximately 24.5% and 39.8%, respectively. Aviation fuel expense accounted for 32.1% of our total operating expenses in 2005, as compared to 26.8% in 2004.

Aircraft depreciation and operating lease expenses increased 17.7% from RMB4,467 million in 2004 to RMB5,255 million in 2005 primarily due to an expansion of our fleet size, while partially offset by the termination of



certain operating leases between CEA Northwest and us. The number of the aircraft operated by us increased from 103 as of December 31, 2004 to 180 as of December 31, 2005. Other depreciation, amortization and operating lease expenses increased 37.1% from RMB496 million in 2004 to RMB680 million in 2005 primarily due to our acquisition of certain assets and liabilities relating to the aviation businesses of CEA Northwest and CEA Yunnan.

Wages, salaries and benefits increased 26.4% from RMB1,866 million in 2004 to RMB2,359 million in 2005 primarily due to a significant increase in the number of our employees following our acquisition of certain assets and liabilities relating to aviation businesses of CEA Northwest and CEA Yunnan. The total number of our employees increased by 40.8% from 20,817 as of December 31, 2004 to 29,301 as of December 31, 2005.

Take-off and landing charges, which accounted for 13.4% of our total operating expenses in 2005, increased 23.1% from RMB3,020 million in 2004 to RMB3,719 million in 2005 primarily due to an increase in the number of our flights, while partially offset by a decrease in the average take-off and landing charges resulting from increased deployment of smaller aircraft. The number of our flights increased from approximately 169 thousand in 2004 to approximately 211 thousand in 2005.

Aircraft maintenance expenses increased by 60.9% from RMB860 million in 2004 to RMB1,384 million in 2005 primarily due to an expansion of our fleet size in 2005.

Commission expenses increased 25.6% from RMB772 million in 2004 to RMB970 million in 2005 primarily due to an increase in tickets sales by agents.



Food and beverage expenses increased 28.9% from RMB758 million in 2004 to RMB977 million in 2005. This increase was primarily due to an 37.2% increase in the number of passengers carried from approximately 17.71 million in 2004 to approximately 24.29 million in 2005.

Office and administration expenses increased by 33.8% from RMB1,463 million in 2004 to RMB1,958 million in 2005 primarily due to our acquisition of certain assets and liabilities relating to the aviation businesses of CEA Northwest and



CEA Yunnan. Office expenses, transportation expenses and travel, business trips and entertainment expenses increased from RMB472 million, RMB55 million and RMB202 million, respectively, in 2004 to RMB673 million, RMB146 million and RMB324 million, respectively, in 2005.

SITA ticket reservation system charges increased 39.0% from RMB210 million in 2004 to RMB292 million in 2005 primarily due to an increase in the number of passengers we carried.

Other operating expenses increased by 45.1% from RMB646 million in 2004 to RMB938 million in 2005 primarily due to an increase in the amount of civil aviation infrastructure levy payable to the Civil Aviation Administration of China from RMB251 million in 2004 to RMB466 million in 2005.

Other Operating Income. Our other operating income was primarily generated from government subsidies and fair value gains on financial instruments held by us. The net amount of our other operating income increased from RMB85 million in 2004 to RMB245 million in 2005 primarily due to an increase in government subsidies from RMB74

million in 2004 to RMB193 million in 2005, see Note 6 to our audited consolidated financial statements.

Finance Costs. Our finance costs decreased by 8.2% from RMB770 million in 2004 to RMB707 million primarily due to the recognition of a net exchange gain of RMB415 million in 2005, while partially offset by an increase in interest expenses of RMB251 million. In 2004, we received a waiver of amount due to CEA Northwest in a value of RMB133 million under certain aircraft operating leases between CEA Northwest and us.

Net Loss. As a result of the foregoing operating results, net loss attributable to shareholders was RMB467 million in 2005, as compared to a net profit of RMB321 million in 2004.

Fixed Assets. Our company had approximately RMB38,348 million of fixed assets as of December 31, 2005, including aircraft, engines and flight equipment with a value of approximately RMB34,740 million. Fixed assets are initially recognized at cost and are subsequently stated at revalued amount, being its fair value at the date of revaluation less any subsequent accumulated depreciation.

Valuation of fixed assets is affected by market conditions and global economic factors that are not within our control.



The determination of fair value requires significant judgment, including judgment on valuations by our management and/or by independent professional appraisers. Our directors have reviewed the carrying value of our fixed assets as of December 31, 2005 and are of the opinion that the carrying amount is not materially different from the fair value of such fixed assets.

Liquidity and Capital Resources

We typically finance our working capital requirements through a combination of funds generated from operations and short-term bank loans. As a result, our liquidity could be adversely affected to the extent there is a significant decrease in demand for our services or if there is any delay in obtaining bank loans. As of December 31, 2004 and 2005, we had cash and cash equivalents of RMB2,114 million and RMB1,864 million, respectively. In 2004 and 2005, our net cash inflows generated from operating activities were RMB3,266 million and RMB1,952 million, respectively, while our net cash outflows used in investment activities were RMB2,433 million and RMB10,369 million, respectively. In the past two years, our primary cash requirements for investment activities were related to our acquisitions and upgrades of aircraft and flight equipment, debt repayments and our acquisition of certain assets and liabilities relating to the aviation businesses of CEA Northwest and CEA Yunnan.

In 2004 and 2005, payment of advances on aircraft and flight equipment were RMB2,679 million and RMB9,073 million, respectively, while additions of aircraft and flight equipment were RMB1,997 million and RMB7,751 million, respectively. We financed the additions to our aircraft and flight equipment primarily through lease arrangements, bank loans and funds generated from operations. Funds generated from disposal of old aircraft and flight equipment

and other fixed assets and equipment (including by way of exchange) totaled RMB668 million and RMB33 million in 2004 and 2005, respectively. Our net cash inflow generated from financing activities was RMB8,186 million in 2005, primarily from proceeds from bank loans and the issue of short-term debentures.

Pursuant to certain of our finance or operating leases, we are required to indemnify the lessors against any withholding or similar taxes that may be imposed on the lessors by taxing authorities in China with regard to payments made under such leases. Pursuant to a regulation issued in 2000 by the State Tax Bureau of China, lease payments made by



Chinese airlines to foreign enterprises in respect of lease arrangements entered into prior to September 1, 1999 are exempt from the payment of any withholding tax. Withholding tax payable in respect of the lease arrangements entered into on or after September 1, 1999 are charged to our income statement as incurred.

We generally operate with a working capital deficit. As of December 31, 2005, our current liabilities exceeded our current assets by RMB25,598 million. In comparison, our current liabilities exceeded our current assets by RMB12,491 million as of December 31, 2004. The increase in our current liabilities in 2005 was primarily due to an

increase in borrowings for payment of advances on aircraft and flight equipment. Short-term loans outstanding totaled RMB6,189 million and RMB13,711 million as of December 31, 2004 and 2005, respectively. Long-term bank loans outstanding totaled RMB10,736 million and RMB12,659 million as of December 31, 2004 and 2005, respectively. Long-term loans payable within two years, from three to five years and beyond five years were RMB2,663 million, RMB5,517 million and RMB1,609 million, respectively, as of December 31, 2005, as compared to RMB2,387 million, RMB3,216 million and RMB1,940 million, respectively, as of December 31, 2004. The total lease obligations outstanding under our finance leases as of December 31, 2004 and 2005 were RMB8,662 million and RMB10,608 million, respectively. Our lease obligations payable within two years, from three to five years and beyond five years were RMB2,570 million, RMB3,014 million and RMB2,596 million, respectively, as of December 31, 2005, as compared to RMB1,670 million, RMB3,756 million and RMB2,017 million, respectively, as of December 31, 2004.

We have, and in the future may continue to have, substantial debts. As of December 31, 2004 and 2005, our long-term debt to equity ratio was 2.6 and 3.4, respectively. The interest expenses associated with these debts might impair our future profitability. We expect that cash from operations and bank borrowings will be sufficient to meet our operating cash flow requirements, although events that materially affect our operating results can also have a negative impact on liquidity. We have entered into credit facility agreements with certain Chinese banks to meet our future working capital needs. We have arranged, and we believe that we will continue to be able to arrange, short-term bank loans with domestic and foreign-funded banks in China as necessary to meet our working capital requirements. However, our ability to obtain financing may be affected by our financial position and leverage and credit ratings, as well as by prevailing

economic conditions and the cost of financing generally. If we are unable to obtain financing for a significant portion of our capital requirements, our ability to acquire new aircraft and to expand our operations may be adversely affected.

Capital Expenditures

Our aircraft orders as of December 31, 2005 included commitments to acquire 47 aircraft to be delivered in 2006 and 2007. We expect our capital expenditures for aircraft and related equipment, including deposits, through 2010 to be in aggregate approximately RMB57,332 million, including RMB19,080 million in 2006 and RMB12,704 million in 2007, in each case subject to contractually stipulated increases or any increase relating to inflation. We generally finance our purchase of aircraft through operating leases and bank loans secured by our assets. As of December 31, 2005, the total value of our mortgaged assets increased by 1.1%, from RMB9,737 million as of December 31, 2004 to RMB9,844 million as of December 31, 2005. Construction of our facilities at the Pudong International Airport and the purchase of maintenance equipment and other property and equipment will continue to require additional capital expenditures in 2006. We paid an amount of RMB418 million as the consideration for the increase of our equity interest in China Eastern Airlines Wuhan Limited



to 96% early 2006. We plan to finance our other capital commitments through a combination of funds generated from operations, existing credit facilities, bank loans, leasing arrangements and other external financing arrangements.

Foreign Currency Transactions

We have debts denominated in U.S. dollars, Japanese yen or Euro in addition to our debts denominated in Renminbi. We generate a significant amount of foreign currency revenues, including U.S. dollar, Japanese yen, Euro, Korean won, Hong Kong dollar, Singapore dollar, Australian dollar, and Thailand baht revenues, from ticket sales made in overseas offices. Pursuant to current foreign exchange regulations in China, we may retain our foreign currency earnings subject to the approval of SAFE. We have also designated certain personnel to manage the foreign currency risks through derivative financial products such as forward foreign exchange contracts and interest rate swaps. We use interest rate swaps to reduce risks related to changes in market interest rates. As of December 31, 2005, the notional amount of the outstanding interest rate swap agreements was approximately US\$661 million, compared to US\$437 million as of December 31, 2004. These interest rate swap agreements will expire between 2006 and 2016. In addition, we use currency forward contracts to reduce risks related to changes in currency exchange rates in respect of ticket sales and expenses denominated in foreign currencies. As of December 31, 2005, the notional amount of the outstanding currency forward contracts was approximately US\$92 million, compared to US\$226 million as of December 31, 2004. This decrease in the notional amount of the outstanding currency forward contracts was primarily due to the cancellation or early termination of certain currency forward contracts in 2005. These currency forward contracts will expire between 2007 and 2010.

Pursuant to IFRS, our monetary assets and liabilities denominated in foreign currencies are required to be translated into Renminbi at the year end at exchange rates announced by the People's Bank of China. The net exchange gains or losses are recognized and reflected in the income statement for the relevant year. Any fluctuation of the exchange rates between Renminbi and foreign currencies may materially adversely affect our financial condition and results of operations. Primarily due to an appreciation of Renminbi against certain foreign currencies including U.S. dollar, Japanese yen and Euro following the measures introduced by the PRC government in July 2005 to reform the Renminbi exchange rate regime, we recognized a net exchange gain of RMB415 million in 2005, compared to a net exchange loss of RMB32 million in 2004.

