



## BUSINESS REVIEW OF THE COMPANY AND AIR CHINA CARGO

**Passenger services:** In 2006, the Company's passenger traffic reached 60,322 million RPKs, representing an increase of 15.1% from 2005. Passenger traffic from international routes, Mainland China routes and Hong Kong and Macau routes increased by 16.5%, 14.1% and 13.2% respectively. The higher growth in international routes compared with Mainland China and Hong Kong and Macau routes reflected the robust growth potential of the international aviation markets. For 2006, the number of passengers carried increased by 13.8% from 2005 to 31.50 million, available seat kilometres of the Company increased by 12.4% from 2005 to 79,442 million kilometres, while passenger load factor increased by 1.7 percentage points from 2005 to 75.9% and revenue per RPK increased by 3.5% from 2005 to RMB0.59.

**Cargo and mail services:** During 2006, turnover volume of cargo and mail of Air China Cargo increased by 19.0%

from 2005 to 3,285 million RFTKs. Cargo and mail carried increased by 15.2% from 2005 to 844,600 tonnes. For 2006, available freight tonne-kilometres of the Company increased by 20.8% from 2005 to 6,117 million, while freight and mail load factor decreased by 0.8 percentage points from 2005 to 53.7%, and cargo yield per RFTK decreased by 6.4% from 2005 to RMB1.9.

## BUSINESS REVIEW OF AIR MACAU

The Company holds 51% of the issued share capital of Air Macau through China National Aviation Corporation (Macau) Company Limited, a wholly-owned subsidiary of CNAC. 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 2006 are set out as follows:

	2006	2005	Change
<b>Traffic</b>			
<b>RPK (in millions)</b>	<b>3,039.5</b>	2,449.8	24.1%
<b>RFTK (in millions)</b>			
Passenger aircraft	28.9	22.5	28.4%
Freights	163.4	147.5	10.8%
<b>Passengers carried (in thousands)</b>	<b>2,466.9</b>	2,059.6	19.8%
<b>Cargo and mail (in tonnes)</b>			
Passenger aircraft	23,130	19,251	20.1%
Freighters	151,592	132,662	14.3%
<b>Capacity</b>			
<b>ASK (in millions)</b>	<b>4,050.3</b>	3,425.4	18.2%
<b>ATK (in millions)</b>			
Passenger aircraft	471.4	392.4	20.1%
Freighters	220.8	206.9	6.7%

# Business Overview



## BUSINESS REVIEW OF PRINCIPAL ASSOCIATES

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

The Company holds 22.8% of the issued share capital of Shandong Airlines. Shandong Aviation Group Corporation, in which the Company owns 48% of its issued share capital, also holds 42.0% of the issued share capital of Shandong Airlines. During 2006, the total traffic turnover of Shandong Airlines increased by 31.4% from 2005 to 577 million tonne kilometres, while passengers carried increased by 34% from 2005 to 5.37 million. Shandong Airlines handled 50,712 tonnes of cargos and mails, representing an increase of 31.8% as compared to 2005.

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

The Company holds 25% of the issued share capital of Shenzhen Airlines. During 2006, the total traffic turnover of Shenzhen Airlines increased by 26.5% from 2005 to 1.06 billion tonne kilometers, while passengers carried increased by 24.3% from 2005 to 7.12 million. Shenzhen Airlines handled 105,933 tonnes of cargos and mails, representing an increase of 27.3% as compared to 2005.

## HUB BUILDING

During 2006, through expanding transport capacity, securing time slots and improving flight connection, the Company pushed forward its complex hub building in Beijing and accelerated the progress of building the regional hub in Chengdu and the international gateway in Shanghai, and, in particular, reinforced its market control over the Beijing hub and improved the quality of hub operation.

Beijing is one of the most important international gateways and domestic transit hubs in China and has excellent potential in becoming a domestic-international and international-domestic complex hubs. In 2006, passenger throughput of the Company at the Beijing base was 18.54 million, representing a market share of 43.8%, while cargo and mail throughput was 531,000 tonnes, representing a market share of 51.8%. During the reporting period, the Company increased the number of aircraft serving the Beijing hub to 123, which was an addition of 19 aircraft compared with 2005. As for flight connection, the Company reinforced its competitive edge in transit connection of international and domestic networks, increasing the total number of connecting flights available per week by 18% compared to the same period last year to 42,900. The number of connecting flights for each international outbound flight increased from 14 to 15.1 and the number of connecting flights for each international inbound flight increased from 14.1 to 15.4.

Compared with other domestic airlines, the Company has the most extensive route network in southwestern China with particular strength in main routes within the region, such as Chengdu-Lhasa and Chengdu-Jiuzhai routes. In 2006, the Company strengthened its hub building in Chengdu district and actively developed the highland routes so as to form a regional hub network between main domestic routes and the highland routes which interconnect with and dependence on each other, representing a market share of 37%. The Company also increased flight frequency and connecting points and gave priority to those connecting points which are supported by local base. The Company strengthened the market share of its main domestic routes and proactively developed key routes throughout Southern Asia and the South East Asia by taking advantage of its regional edge.

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, representing a market share of 12.3%. In accordance with the principles of “coordinated development between international and domestic routes, enhancement of international routes and reinforcement of domestic routes”, the Company proactively develops the routes between Shanghai and each of the bases of Air China and its branches and further ensures the smooth connections between domestic flights and international flights. Meanwhile, the Company also proactively develops the routes between Shanghai and major cities in Japan



and Korea and the regional routes originating from Shanghai in anticipation to connect the above routes with the routes originating from Shanghai to Europe and America and the key domestic routes.

## ROUTE NETWORK

As an important step for hub building, the Company continued to optimize and expand its route network structure. The available seat kilometers in respect of international routes grew by 14.0% compared to the same period last year. The Company established new international routes departing from Beijing to Ho Chi Minh City, Delhi, Madrid and Sao Paulo etc. Leveraging on the new route rights offered, the Company launched new routes from Tianjin and Dalian to Seoul, resulting in adjustments in the route structure in relation to Australia and San Francisco, and increasing the flight frequency of key routes serving Europe and America and the profitable routes serving Japan and Korea. By introducing aircraft with the "New First and Business Class Cabins" to routes serving Europe and America regularly, the Company has remarkably improved the service quality of the routes and enhanced our competitiveness in the market.

The available seat kilometers expansion in respect of domestic routes increased by 11.6% compared to the same period last year. According to the demand for routes network expansion, and in order to satisfy the local economic development needs, the Company launched 30

domestic routes, including the Chengdu – Shenyang route. While maintaining a stable increase in the transport capacity of major domestic routes serving between different bases, the Company has also been strengthening the transport capacity of domestic routes that are profitable and making contribution to our network. Measures such as increasing flight frequency, redeploing the aircraft models and making adjustment to routes structure so as to improve the profitability of our domestic routes.

The annual available seat kilometers expansion of regional routes increased by 4.5% compared to the same period last year. The Company increased the flight frequency of routes from Beijing, Tianjin, Chengdu and other cities to Hong Kong, which not only meet the demand of domestic travellers, but also provide adequate domestic routes support for products sold in Hong Kong.

## FLEET

The fleet of the Company continued to expand. During the year, there was a net increase of 31 aircraft (in which 35 aircraft were introduced and 4 aircraft were retired) of both the Company and Air China Cargo. As at 31 December 2006, the Company and Air China Cargo operated a fleet of 207 aircraft in total with an average age of 7.6 years (compared to 8.1 years in 2005). Details of the fleet are set out in the table below:



# Business Overview

Type of aircraft	Owned	Number of Aircraft		Total
		Finance Leased	Operating Leased	
<b>Passenger Aircraft</b>	<b>89</b>	<b>55</b>	<b>52</b>	<b>196</b>
Airbus	27	14	9	50
Boeing	62	41	38	141
CRJ-200	–	–	5	5
<b>Freighters</b>	<b>6</b>	<b>–</b>	<b>3</b>	<b>9</b>
<b>Business Jet</b>	<b>–</b>	<b>–</b>	<b>2</b>	<b>2</b>
<b>Total</b>	<b>95</b>	<b>55</b>	<b>57</b>	<b>207</b>



As at 31 December 2006, Air Macau operated a fleet of 18 aircraft, of which 14 are passenger aircraft and 4 are freighters.

In January 2006, the Company and Air China Group Import and Export Trading Co. (“AIE”, a wholly-owned subsidiary of the Company) entered into an agreement with Dragonair for the wet lease of 2 A330-300 aircraft.

In January 2006, the Company and AIE entered into an aircraft lease agreement with ILFC for the lease of 3 B737-800 aircraft and an aircraft lease agreement with GECAS for the lease of 5 B737-800 aircraft.

On 17 January 2006, the Company and AIE entered into an agreement with Boeing for the purchase of 10 B737-800 aircraft.

On 26 March 2006, the Company and Shandong Airlines entered into an agreement whereby the Company renewed the wet lease of 3 CRJ-200 aircraft and leased 2 additional CRJ-200 aircraft resulting in the wet lease an aggregate of 5 CRJ-200 aircraft.

On 31 March 2006, the Company and AIE entered into a purchase agreement with Boeing in respect of the purchase of 15 B737-800 aircraft.

On 26 May 2006, the Company and AIE entered into a purchase agreement with Airbus S.A.S. for the purchase of 24 A321 aircraft.

Up to 31 December 2006, the Company had completed its renovation work for both the first and business class cabins for 13 aircraft, of which 8 aircraft were completed in 2006, including 5 B747-400 aircraft and 3 A340-300 aircraft.

## MARKET EXPANSION

During the reporting period, the Company expanded its direct sales channels, developed e-commerce and accelerated the development of electronic tickets. The Billing and Settlements Plan (“BSP”) electronic passenger ticketing was made available to all domestic BSP agents. The electronic passenger ticketing operation was also commenced in 68 domestic destinations while itinerary was available to passengers at 46 airports. The Company achieved the combined transportation by electronic tickets with various airlines. The Company continued to drive forward the construction of call centers to further expand overseas sales channels and to improve service quality. A website for the North America region was formally launched on 25 September 2006 to handle the sale activities in the region, which established the Company’s overseas direct sales channels for the North America market. The operation of our call center project in Europe will also be commenced soon which offers 6 languages to provide telemarketing services in 15 European countries.

During the reporting period, the Company took favorable measures on managing issues relating to the European and American routes, “New First and Business Class Cabins” yield, transit and joint sales, routes adjustment, key account management and frequent flyers development, and achieved our expected target. Income generated from the first and business classes amounted to RMB3.79 billion, representing an increase of 19.8% compared to the same period last year. Income from the routes in relation to “New First and Business Class Cabins” increased by RMB120 million, and income from the two classes account for 33% of total income generated from the routes of “New First and Business Classes Cabins”. Income from joint sales was RMB8.59 billion, representing an increase of 25.1% compared to the same



period last year. The number of transit passengers in Beijing and Chengdu increased by 20% compared to the same period last year, accounting for 17% and 15% respectively of its transit passengers. The Company terminated certain routes that made no marginal contribution and improved key account management level. The frequent flyers of the Company increased by 1,117,000 in 2006, resulting in total membership reaching 4,102,000, and the income from frequent flyers reached RMB6.75 billion.

2006 was an important year for the marketing campaign in relation to the Olympic Games. The Company has formulated a three-year plan for the Olympic Games, which includes 54 activities in 13 categories such as flight marketing, overseas marketing, outlet sales and staff incentives. The Company has launched innovative services, promoted its image in connection with Olympic Games and enhanced its customers' and the public's awareness and recognition of Air China.

## BUSINESS COOPERATION

On 22 May 2006, the Company entered into a Memorandum of Understanding with Star Alliance, and formally declared its intention to join Star Alliance. The Company has continued to strengthen its business relationship with some important partners such as Lufthansa and United Airlines. Meanwhile, the Company has proactively explored new partnership and also commenced to implement the code sharing arrangement with several airlines in Brazil, Australia and New Zealand as well as the Virgin Atlantic Airways. Besides, the Company has conducted a full code sharing cooperation with Shandong Airlines on the China-Korea routes and has agreed on with Macau Airlines in connection with the intention on free-sales cooperation.

## POST BALANCE SHEET EVENTS

On 23 January 2007, the scheme of arrangement for the privatisation of CNAC was formally approved by the court in Hong Kong. The listing of CNAC on the Stock Exchange of Hong Kong Limited (the "Stock Exchange") was withdrawn will effect from 9:30 a.m. on 25 January 2007.

On 31 January 2007, the board of directors of the Company adopted the resolutions which resolved that Mr. Ma Xulun ceased to act as the President of the Company while Mr. Cai Jianjiang, who ceased to act as the Vice President of the Company, was appointed to act as the President of the Company, and Mr. Tan Zhihong was appointed to act as the Vice President of the Company. The above appointments became effective on 1 February 2007.

On 26 February 2007, the Federal Judiciary of the United States filed a civil summon against the Company and Air China Cargo claiming that they, together with a number of other airlines, have violated certain anti-trust regulations in respect of their air cargo operations in the United States and the European Union. The status of the proceedings is still in the preliminary stage and therefore the Directors of the Company and Air China Cargo are of the view that it is not possible to estimate the eventual outcome of the claim with reasonable certainty at this stage. Also, the Directors of the Company and Air China Cargo are of the view that there would be valid defense against this claim and considered that no provision for this claim was needed accordingly.

The details of other post balance sheet events are set out in note 49 of the financial statements.