

Report of the Directors

The Board of the Company hereby presents this report and the financial statements of the Company and the Group for the year ended 31 December 2006 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 2006 and the financial positions of the Company and the Group as at the same date are set out in the audited financial statements on pages 55 to 133 of this annual report.

DIVIDEND

The Board recommends the payment of a final dividend of RMB0.492 per 10 shares for the year ended 31 December 2006, totalling approximately RMB603 million. A resolution for the dividend payment will be submitted for consideration at the annual general meeting to be convened on 30 May 2007. The dividend will be denominated and declared in Renminbi. Dividend on domestic shares will be paid in Renminbi, whereas 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 dividend. This recommendation has been incorporated in the financial statements as an allocation of retained profits within the equity section of the balance sheet.

TAXATION ON DIVIDEND

Taxes paid by PRC companies are generally PRC withholding tax levied at a flat rate of 20%. However, pursuant to one of the 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.

FIVE-YEAR FINANCIAL HIGHLIGHTS

The summary of the Group's published results, assets, liabilities and minority interest under IFRS for the five years ended 31 December 2006 are set out under the section headed "Summary of Financial Information" on page 3 of this annual report.

SHARE CAPITAL

The Company issued 1,179,151,364 H shares in 2006, the total number of H shares in issue at the end of this reporting period was 4,405,683,364 shares. As at 31 December 2006, the total share capital of the Company was RMB12,251,362,273, divided into 12,251,362,273 shares with a par value of RMB1.00 each. Details of movements in the Company's share capital during the year are set out in note 38 to the financial statements. The following table sets out the share capital structure of the Company as at 31 December 2006:

Category of Shares	Number of shares	Percentage of the total issued share capital
Domestic shares listed in Mainland China	7,845,678,909	64.04%
H shares	4,405,683,364	35.96%
Total	12,251,362,273	100%

PURCHASES, SALES AND REDEMPTION OF SHARES

During the year ended 31 December 2006, neither the Company nor any of its subsidiaries purchased, sold or redeemed any of the Company's securities. For this purpose, the expression "securities" has the meaning ascribed to it under the Listing Rules.

PRE-EMPTIVE RIGHTS

None of the articles of association of the Company provide for any pre-emptive rights requiring the Company to offer new shares to existing shareholders in proportion to their existing shareholdings.

SIGNIFICANT INTERESTS AND SHORT POSITIONS IN SHARES, UNDERLYING SHARES AND DEBENTURES OF THE COMPANY

As at 31 December 2006, to the knowledge of the Directors, Supervisors and Chief Executives of the Company, the interests and short positions of the following persons (other than a Director, Supervisor or Chief Executive of the Company) who have an interest or short position in the shares, underlying shares and debentures of the Company which would fall to be disclosed to the Company pursuant to the Securities and Futures Ordinance (the "SFO"), or who are, directly or indirectly, interested in 10% or more of the nominal value of any class of share capital carrying rights to vote in all circumstances at general meetings of any members of the Group are as follows:

(a) Substantial interests in the Company

Name of shareholder	Type of interests	Type and number of shares of the Company	Percentage of the total issued share capital of the Company	Percentage of the total issued domestic shares of the Company	Percentage of the total issued H shares of the Company	Short position
China National Aviation Holding Company ("CNAHC")	Beneficial owner	4,949,066,567 domestic shares	40.40%	63.08%	–	–
CNAHC ⁽¹⁾	Attributable interests	1,380,482,920 domestic shares	11.26%	17.60%	–	–
China National Aviation Corporation (Group) Limited ("CNACG")	Beneficial owner	1,380,482,920 domestic shares	11.26%	17.60%	–	–
Cathay	Beneficial owner	2,124,818,455 H Shares	17.34%	–	48.23%	–
Swire Pacific Limited ⁽²⁾	Attributable interests	2,124,818,455 H Shares	17.34%	–	48.23%	–
John Swire & Sons Limited ⁽²⁾	Attributable interests	2,124,818,455 H Shares	17.34%	–	48.23%	–
John Swire & Sons (H.K.) Limited ⁽²⁾	Attributable interests	2,124,818,455 H Shares	17.34%	–	48.23%	–
JPMorgan Chase & Co. ⁽³⁾	Investment manager	391,255,100 H Shares	3.19%	–	8.88%	–
		128,628,100 H Shares (Lending Pool)	1.05%	–	2.92%	–
Morgan Stanley ⁽⁴⁾	Investment manager	305,497,168 H Shares	2.47%	–	6.93%	–
		54,121,293 H Shares (Short position)	0.44%	–	1.23%	54,121,293 H Shares

Report of the Directors

Notes:

Based on the information available to the Directors, Supervisors and Chief Executives of the Company (including such information available on the website of the Stock Exchange) and so far as the Directors, Supervisors and Chief Executives are aware, as at the latest practicable date:

1. By virtue of CNAHC's 100% interest in CNACG, CNAHC is deemed to be interested in the 1,380,482,920 domestic shares of the Company directly held by CNACG.
2. By virtue of John Swire & Sons Limited's 100% interest in John Swire & Sons (H.K.) Limited and their approximately 33.28% equity interest and 54.35% voting rights in Swire Pacific Limited, and Swire Pacific Limited's approximately 39.95% interest in Cathay, John Swire & Sons Limited, John Swire & Sons (H.K.) Limited and Swire Pacific Limited are deemed to be interested in the 2,124,818,455 H shares of the Company directly held by Cathay.
3. JPMorgan Chase & Co, through its controlled entities, had an attributable interest in 391,255,100 H shares of the Company, out of which the interest in 128,628,100 H shares was held directly by JPMorgan Chase Bank, N.A., 215,790,000 H shares was held directly by JF Asset Management Limited, 13,746,000 H shares was held directly by JF International Management Inc., 7,909,000 H shares was held directly by J.P. Morgan Whitefriars Inc., 1,400,000 H shares was held directly by J.P. Morgan Securities Ltd., 22,720,000 H shares was held directly by JPMorgan Asset Management (Japan) Limited and 1,062,000 H shares was held directly by JF Asset Management (Singapore) Limited, and 128,628,100 H shares of the Company as lending pool.
4. Morgan Stanley, through its controlled entities, had an attributable interest in 305,497,168 H shares of the Company and maintained a short position of 54,121,293 H shares of the Company, out of which Morgan Stanley Investment Management Company directly held 229,336,000 H shares, Morgan Stanley & Co International Limited directly held 15,427,895 H shares and maintained a short position of 5,415,748 H shares, Morgan Stanley Dean Witter Hong Kong Securities Limited directly held 31,657 H shares and maintained a short position of 100,000 H shares, Morgan Stanley Asset & Investment Trust Management Co., Limited directly held 10,946,000 H shares, MSDW Equity Finance Services (Cayman) Limited directly held 13,414,000 H shares and maintained a short position of 13,414,000 H shares, Morgan Stanley Capital (Cayman Islands) Limited maintained a short position of 4,326,000 H shares, Morgan Stanley Capital Services Inc. directly held 449,634 H shares and maintained a short position of 169,720 H shares, Morgan Stanley Capital (Luxembourg) S.A. directly held 5,086,200 H shares, and Morgan Stanley & Co. Inc. directly held 30,805,782 H shares and maintained a short position of 30,695,825 H shares.

(b) Substantial interests in CNAC

As at 31 December 2006, the interests and short positions of the following persons in the shares, underlying shares and debentures 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 shareholder	Type of interests	Number of shares of CNAC	Percentage of the total issued share capital of CNAC
Air China	Beneficial owner	2,264,628,000 ⁽¹⁾	68.36%
CNAHC	Attributable interest	2,264,628,000 ⁽²⁾	68.36%
Best Strikes Limited	Beneficial owner	187,656,000	5.66%
Novel Credit Limited	Attributable interest	322,856,000 ⁽³⁾	9.75%
Novel Enterprises (BVI) Limited	Attributable interest	322,856,000 ⁽³⁾	9.75%
Novel Enterprises Limited	Attributable interest	322,856,000 ⁽³⁾	9.75%
Novel Holdings (BVI) Limited	Attributable interest	322,856,000 ⁽³⁾	9.75%
Novel Investment Holdings Limited	Attributable interest	322,856,000 ⁽³⁾	9.75%
On Ling Investments Limited	Attributable interest	322,856,000 ⁽³⁾	9.75%
Westleigh Limited	Attributable interest	322,856,000 ⁽³⁾	9.75%

Notes:

- (1) CNACG, the former immediate controlling shareholder of CNAC, transferred approximately 68.36% 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.
- (2) CNAHC owns approximately 51.66% 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 11.26% of the total issued share capital of the Company. Accordingly, CNAHC's interests in CNAC duplicate those in the Company.
- (3) The respective 5.6% 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.

(c) Substantial interests in other members of the Group

Member of the Group	Name of shareholder	Percentage of issued share capital
Air Macau	CNAC	51%
Air Macau	Sociedade de Turismo e Diversões de Macau	14%
Air Macau	Servico, Administracao e Participacoes, Lda.	20%
Aircraft Maintenance and Engineering Corporation ("Ameco")	Deutsche Lufthansa AG	40%
Air China Cargo	Capital Airports Holding Company	24%
Air China Cargo	CITIC Pacific Limited	25%

Save as disclosed above, as at the latest practicable date, to the knowledge of the Directors, Supervisors and Chief Executive of the Company, no other person (other than a Director, Supervisor or Chief Executive of the Company) had an interest or short position in the shares, underlying shares and debentures of the Company which would fall to be disclosed to the Company pursuant to the SFO, or otherwise was, directly or indirectly, interested in 10% or more of the nominal value of any class of share capital carrying rights to vote in all circumstances at general meetings of any members of the Group.

PUBLIC FLOAT

Pursuant to public information available to the Company and to the best knowledge of the Directors of the Company, the Company has maintained a public float as required by the Listing Rules and agreed by the Stock Exchange throughout the current reporting period.

Report of the Directors

DIRECTORS AND SUPERVISORS OF THE COMPANY

Directors

Name	Age	Position in the Group	Date of appointment as director
Li Jiayang	57	Chairman and non-executive director	30 September 2004
Kong Dong	58	Vice chairman and non-executive director	30 September 2004
Wang Shixiang	57	Vice chairman and non-executive director	30 September 2004
Yao Weiting	59	Non-executive director	30 September 2004
Christopher Dale Pratt	50	Non-executive director	12 June 2006
Ma Xulun	42	Executive director and president	30 September 2004
Cai Jianjiang	43	Executive director and vice president	30 September 2004
Fan Cheng	51	Executive director and vice president	18 October 2004
Hu Hung Lick, Henry	87	Independent non-executive director	22 November 2004
Wu Zhipan	50	Independent non-executive director	30 September 2004
Zhang Ke	53	Independent non-executive director	30 September 2004
Jia Kang	52	Independent non-executive director	5 June 2006

Mr. Chen Nan Lok Philip was appointed as a non-executive director in the third extraordinary general meeting held on 28 December 2006. The appointment will come into effect upon the approval from the relevant authorities in respect of the amendments to the articles of association of the Company regarding the number of directors of the Board.

Supervisors

Name	Age	Position in the Group	Date of appointment as supervisor
Zhang Xianlin	53	Chairman of Supervisory Committee	30 September 2004
Liao Wei	42	Supervisor	18 October 2004
Zhang Huilan	46	Supervisor	30 September 2004
Liu Feng	48	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.

BOARD COMMITTEES

The Board committees include the strategy and investment committee, audit and risk control committee, nomination and remuneration committee and aviation safety committee. The Board committees established their respective expert teams to provide advisory or professional services for their decision making. 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

The table below sets out the information of the interests held by the Directors and Supervisors of the Company in the shares, underlying shares and debentures of the Company and its associated corporations, and the short positions and any options in respect of such shares held by each Director and Supervisor (including any associate whose existence the Director or Supervisor is aware of, or can be recognised through reasonable efforts, whether such short positions are held through the another party or not):

Name of interest holder	Position in the Company	Name of associated corporation involved	Number of share options held	Percentage of the relevant associated corporation's issued share capital
Zhang Xianlin	Supervisor	CNAC	33,126,000	1%

During the course of the privatisation of CNAC, Mr. Zhang Xianlin has committed not to exercise any of his share options referred to above.

Save as disclosed above, as at 31 December 2006, none of the Directors, Supervisors or Chief Executives of the Company has interests or short positions in the shares, underlying shares and/or debentures (as the case may be) of the Company or its associated corporations (within the meaning of Part XV of the SFO) which were notified to the Company and the Stock Exchange pursuant to SFO (including interests or short positions which have been taken or deemed to be taken under such provisions of the SFO), or recorded in the register maintained by the Company pursuant to Section 352 of the SFO, or which were notified to the Company and the Stock Exchange pursuant to the Model Code. For this purpose the relevant provisions of the SFO will be interpreted as if they applied to the Company's supervisors.

REMUNERATION OF DIRECTORS AND SUPERVISORS

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

INTERESTS OF DIRECTORS AND SUPERVISORS IN SERVICE CONTRACTS, CONTRACTS AND BUSINESS

Each of the Directors has entered into a service contract with the Company. Except for those with Mr. Fan Cheng, Mr. Jia Kang and Mr. Christopher Dale Pratt, each of the other service contracts has a term of three years from 30 September 2004 and will end on the expiry of the term of the current session of the Board. The terms of the service contracts with Mr. Fan Cheng, Mr. Jia Kang and Mr. Christopher Dale Pratt began on 18 October 2004, 5 June 2006 and 12 June 2006 respectively and will end on the expiry of the term of the current session of the Board. All service contracts with Directors are 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 other member of the Group which is not expiring or terminable by the Group within one year without payment of compensation (other than statutory compensation).

None of the Directors or Supervisors of the Company is materially interested in any contract or arrangement subsisting as at 31 December 2006 and which is significant in relation to the business of the Group.

Mr. Christopher Dale Pratt is a non-executive director of the Company and is concurrently the chairman and executive director of Cathay, which is a substantial shareholder of the Company and wholly owns Dragonair. Mr. Li Jiaxiang is the chairman and a non-executive director of the Company and is concurrently a non-executive director of Cathay. Cathay and Dragonair compete or are likely to compete either directly or indirectly with some aspects of the business of the Company as they operate airline services to certain destinations, which are also served by the Company.

Report of the Directors

Save as above, none of the Directors or Supervisors of the Company and their respective associates (as defined in the Listing Rules) has any competing interests which would be required to be disclosed under Rule 8.10 of the Listing Rules if each of them were a controlling shareholder of the Company.

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

The Company held 14 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, except for the deviations the details of which are set out in "Corporate Governance Report" in this annual report, the Company has complied with the requirements set out in the Code to revise the internal governance structure of the Company.

EMPLOYEES

As at 31 December 2006, the Company had 18,872 employees and its subsidiaries and joint ventures had 13,843 employees. The following table sets forth the numbers and percentages of employees in different departments of the Company:

Employees	31 December 2006	31 December 2005	Net change
Flight crew	4,945	5,066	-121
Pilots	2,590	2,492	98
Flight attendants	2,355	2,574	-219
Ground crew	13,927	13,381	546
Ground services	2,794	2,669	125
Maintenance	3,454	3,297	157
Others	2,061	2,098	-37
Marketing and sales	2,260	2,101	159
Management	3,358	3,216	142
Total	18,872	18,447	425

Note: This table is exclusive of staff who were arranged to work for the Company according to services contracts entered into between the Company and labor agencies, which in turn entered into employment contracts with the aforesaid staff.

COMPENSATION POLICY

Annual salary systems have been adopted for chief executives in state-owned enterprises since 2005 under the requirements of the State-owned Assets Supervision and Administration Commission.

In order to provide incentives to the flight crew, the Board of the Company considered and approved the Proposal on the Reform of Remuneration and Benefits System for the Flight Crew, which came into effect on 1 March 2006.

EMPLOYEES AND EMPLOYEES' PENSION SCHEME

195 employees of the Company retired in 2006. 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 audited financial statements.

SHARE APPRECIATION RIGHTS

The Directors and Senior Management Stock Appreciation Rights Handbook of the Company was considered and approved on the general meeting held on 28 December 2006. Details of the Share Appreciation Rights Scheme are set out in note 41 to the audited financial statements.

SUBSIDIARIES AND ASSOCIATED COMPANIES

Details of the subsidiaries, joint ventures and associates of the Company are set out respectively in notes 18, 19 and 20 to the audited financial statements.

BANK AND OTHER BORROWINGS

Details of the bank loans, other loans and corporate bonds of the Company and the Group are set out in note 34 to the audited financial statements.

FIXED ASSETS

Movements in the fixed assets of the Company and the Group for the year ended 31 December 2006 are set out in note 16 to the audited financial statements.

CAPITALISED INTERESTS

Details of the capitalised interests of the Group for the year ended 31 December 2006 are set out in note 8 to the audited financial statements.

RESERVES

Movements in the reserves of the Company and the Group during the year are set out in note 40 to the financial statements and the Consolidated Statement of Changes in Equity.

DONATIONS

For the year ended 31 December 2006, the Company made donations for charitable and other purposes amounting to RMB49,791,885.

PROPERTY TITLE CERTIFICATE

The Company effected changes of titles of assets e.g. land use rights, buildings and vehicles, in accordance with its undertakings as disclosed in the Company's prospectus dated 3 December 2004. The title transfer procedures for the land use rights and buildings of the Company's headquarters and branches have been substantially completed save for a few regions. The transfer of titles of the remaining properties is still in progress and the Directors consider that this should not have any material adverse effect on the operation of the Company.

MAJOR CUSTOMERS AND SUPPLIERS

For the year ended 31 December 2006, the purchases from the largest supplier accounted for 20.4% of the total purchases of the Group, while purchases from the five largest suppliers accounted for 42.5%. 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 2006, the sales of the Group to the five largest customers accounted for not more than 30% of the total sales of the Group.

Report of the Directors

MATERIAL LEGAL PROCEEDINGS

As at 31 December 2006, save as disclosed in note 44 to the financial statements, the Company was not involved in any significant litigation or arbitration. To the knowledge of the Company, 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 associates (as defined under the Listing Rules) and other connected persons of the Group. The agreements for connected transactions have been renewed as appropriate in accordance with the Listing Rules. Description of the renewed agreements is set out in the Company's circular dated 1 December 2006. Details of those connected transactions conducted in 2006, which are not exempt under Rule 14A.33 of the Listing Rules, are as follows:

I. Continuing Connected Transactions Between the 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.

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 has expired on 31 December 2006.

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 has expired on 31 December 2006.

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 has expired on 31 December 2006.

Report of the Directors

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 the Company's Companion Card members are encouraged to stay at CNATC's hotels by receiving mileage credits for such stay. As consideration, CNATC will pay the Company the equivalent value represented by those mileage credits.

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

- FFP co-operation services: Under the FFP, if the Company's 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 Cooperation Agreement has expired on 31 December 2006.

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 has expired on 31 December 2006.

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.

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 2006.

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 has expired on 31 December 2006.

Report of the Directors

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 has expired on 31 December 2006.

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 has expired on 31 December 2006.

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

Deutsche Lufthansa AG (“Lufthansa”) holds 40% equity interest in and is a substantial shareholder of Ameco, a joint venture 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 Ameco 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 revenue earned from these arrangements are allocated between the parties based on negotiated terms according to airline industry standards;
- special prorated 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 take-off/landing/depot 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.

Report of the Directors

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

Cathay holds 17.3% 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 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.

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 their 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 2006, 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 Diversões 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 of directors of CNAC 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 ended 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 2006 was HK\$59,898,410. 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 authorised 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 2006 was approximately HK\$101,422,571. 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.

Report of the Directors

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 2006 are set out below:

Transactions	Aggregate amount of transactions for the year ended 31 December 2006	
	Cap RMB (in millions)	Actual amount RMB (in millions)
Transactions with the CNAHC Group		
Construction project management services	40.00	2.90
Properties leasing	52.50	48.73
Media and advertising services	26.60	20.57
Tourism services co-operation	51.00	64.35
Comprehensive services	132.00	76.00
Line maintenance and other ground services	50.00	22.63
Financial services:		
Payment of fees and charges	40.00	21.00
Maximum daily outstanding deposits with CNAF	5,000.00	984.06
Maximum daily outstanding loans from CNAF	3,000.00	339.78
Subcontracting of charter flights	700.00	423.38
Sales agency services:		
Aggregate sales of airline tickets and cargo space to the CNAHC Group for resale to end purchasers	533.00	245.41
Aggregate ticket and cargo agency commission and amount of incentives paid by the Company to CNAHC Group	42.00	41.93
Transactions with the Lufthansa Group		
Aggregate amount paid by the Company to the Lufthansa Group	750.00	533.94
Aggregate amount paid by the Lufthansa Group to the Company	600.00	433.47
Transactions with the Beijing Capital Airports Group		
Aggregate amount paid by the Company to the Beijing Capital Airports Group	1,200.00	850.30
Transactions with the Cathay Pacific Group		
Aggregate amount paid by the Company to the Cathay Pacific Group	45.00	19.72

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 2006 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 conducted in accordance with the pricing policies as stated in the relevant agreements;
3. were entered into in accordance with the relevant agreements governing such transactions; and
4. have not exceeded the cap amounts disclosed in the Company's prospectus dated 3 December 2004, except for the aggregate annual amount received by the Group from CNATC which has exceeded the revised cap amount for 2006 disclosed in the Company's circular dated 1 December 2006 pursuant to the Tourism Services Cooperation Agreement.

CONTRACT OF SIGNIFICANCE

Save as disclosed in "Connected Transactions" of this report of Directors, none of the Company or any of its subsidiaries entered into any contract of significance with the controlling shareholder or any of its subsidiaries, and 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 2006. Ernst & Young has audited the attached financial statements prepared in accordance with 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 2007 will be proposed at the Annual General Meeting of the Company to be held on 30 May 2007.

By Order of the Board



Li Jiaxiang
Chairman

Beijing, PRC
19 March 2007