CHINA SOUTHERN AIRLINES CO LTD
Form 20-F
June 30, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 20-F

(Mark One)

o **REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934**

OR

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2005

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

OR

o **SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Date of event requiring this shell company report....................

For the transition period from ____________________ to ____________________

Commission file number 1-14660

(Exact name of Registrant as specified in its charter)
CHINA SOUTHERN AIRLINES COMPANY LIMITED

(Translation of Registrant s name into English)
THE PEOPLE S REPUBLIC OF CHINA

(Jurisdiction of incorporation or organization)
278 JI CHANG ROAD
GUANGZHOU
PEOPLE S REPUBLIC OF CHINA, 510405

(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act.

Title of each class	Name of each exchange on which registered
Ordinary H Shares of par value RMB 1.00 per share represented by American Depositary Shares	*New York Stock Exchange, Inc.*

Securities registered or to be registered pursuant to Section 12(g) of the Act.

None

(Title of Class)

(Title of Class)

SEC 1852 (05-06) **Persons who respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB control number.**

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act.

None

(Title of Class)

Indicate the number of outstanding shares of each of the issuer s classes of capital or common stock as of the close of the period covered by the annual report. 2,200,000,000 ordinary Domestic Shares of par value RMB 1.00 per share and 1,174,178,000 ordinary H Shares of par value RMB 1.00 per share and 1,000,000 ordinary A Shares of par value RMB 1.00 per share were issued and outstanding as of December 31, 2005.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

o Yes þ No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

o Yes þ No

Note Checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from their obligations under those Sections.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

þ Yes o No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

Indicate by check mark which financial statement item the Registrant has elected to follow.

o Item 17 þ Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

o Yes þ No

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FORWARD-LOOKING STATEMENTS

This Annual Report contains forward-looking statements. These statements appear in a number of different places in this Annual Report. A forward looking statement is usually identified by the use in this Annual Report of certain terminology such as estimates , projects , expects , intends , believes , plans , anticipates , or their negatives or comparable words. Also look for discussions of strategy that involve risks and uncertainties. Forward-looking statements include statements regarding the outlook for the Company s future operations, forecasts of future costs and expenditures, evaluation of market conditions, the outcome of legal proceedings (if any), the adequacy of reserves, or other business plans. You are cautioned that such forward-looking statements are not guarantees and involve risks, assumptions and uncertainties. The Company s actual results may differ materially from those in the forward-looking statements due to risks facing the Company or due to actual facts differing from the assumptions underlying those forward-looking statements.

Some of these risks and assumptions, in addition to those identified under Item 3, Key Information Risk Factors, include:

- general economic and business conditions, including changes in interest rates;
- prices and other economic conditions;
- natural phenomena;
- actions by government authorities, including changes in government regulation;
- the Company s relationship with CSAHC;
- uncertainties associated with legal proceedings;
- technological development;
- future decisions by management in response to changing conditions;
- the Company s ability to execute prospective business plans; and
- misjudgments in the course of preparing forward-looking statements.

The Company advises you that these cautionary remarks expressly qualify in their entirety all forward-looking statements attributable to the Company, the Group, and persons acting on their behalf.

INTRODUCTORY NOTE

In this Annual Report, unless the context indicates otherwise, the Company means China Southern Airlines Company Limited, a joint stock company incorporated in China on March 25, 1995, the Group means the Company and its consolidated subsidiaries, and CSAHC means China Southern Air Holding Company, the Company s parent company which holds a 50.3% controlling interest in the Company.

References to China or the PRC are to the People s Republic of China, excluding Hong Kong, Macau and Taiwan. References to Renminbi or RMB are to the currency of China, references to U.S. dollars , $ or US$ are to the cur of the United States of America (the U.S. or United States), and reference to HK$ is to the currency of Hong Kong. Reference to the Chinese Government is to the national government of China. References to Hong Kong or Hong Kong SAR are to the Hong Kong Special Administrative Region of the People s Republic of China. References to Macau or Macau SAR are to the Macau Special Administrative Region of the People s Republic of China.

The Company presents its consolidated financial statements in Renminbi. The consolidated financial statements of the Company as of December 31, 2004 and 2005 (the Financial Statements) have been prepared in accordance with International Financial Reporting Standards (IFRS) promulgated by the International Accounting Standards Board. IFRS includes International Accounting Standards (IAS) and related interpretations. IFRS differs in certain significant respects from accounting principles generally accepted in the United States of

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America (U.S. GAAP). Information relating to the nature and effect of such differences is presented in Note 50 to the Financial Statements.

Solely for the convenience of the readers, this Annual Report contains translations of certain Renminbi amounts into U.S. dollars at the rate of US$1.00 = RMB8.0694, which is the average of the buying and selling rates as quoted by the People s Bank of China at the close of business on December 31, 2005. No representation is made that the Renminbi amounts or U.S. dollar amounts included in this Annual Report could have been or could be converted into U.S. dollars or Renminbi, as the case may be, at any particular rate or at all. Any discrepancies in the tables included herein between the amounts listed and the totals are due to rounding.

GLOSSARY OF AIRLINE INDUSTRY TERMS

In this Annual Report, unless the context indicates otherwise, the following terms shall have the respective meanings set forth below.

Capacity Measurements

available seat kilometers or ASKs	the number of seats made available for sale multiplied by the kilometers flown
available ton kilometers or ATKs	the number of tons of capacity available for the transportation of revenue load (passengers and cargo) multiplied by the kilometers flown

Traffic Measurements

revenue passenger kilometers or RPKs	the number of revenue passengers carried multiplied by the kilometers flown
cargo ton kilometers	the cargo load in tons multiplied by the kilometers flown
revenue ton kilometers or RTKs	the load (passenger and cargo) in tons multiplied by the kilometers flown

Yield Measurements

passenger yield	revenue from passenger operations divided by RPKs
cargo yield	revenue from cargo operations divided by cargo ton kilometers
average yield	revenue from airline operations (passenger and cargo) divided by RTKs
ton	a metric ton, equivalent to 2,204.6 pounds

Load Factors

passenger load factor	RPKs expressed as a percentage of ASKs
overall load factor	RTKs expressed as a percentage of ATKs
breakeven load factor	the load factor required to equate scheduled traffic revenue with operating costs assuming that total operating surplus is attributable to scheduled traffic operations

Utilization	
utilization rate	the actual number of flight hours per aircraft per operating day
Equipment	
rotables	aircraft parts that are ordinarily repaired and reused
expendables	aircraft parts that are ordinarily used up and replaced with new parts

PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS.

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE.

Not applicable.

ITEM 3. KEY INFORMATION.

Selected Financial Data

The following tables present selected financial data of the Company as of and for each of the years in the five-year period ended December 31, 2005. The selected data of consolidated statements of operations for each of the years in the three-year period ended December 31, 2005 and consolidated balance sheets as of December 31, 2004 and 2005 have been derived from the consolidated financial statements of the Company, including the related notes, included elsewhere in this Annual Report. The selected IFRS data of consolidated statements of operations for the years ended December 31, 2001 and 2002 and IFRS consolidated balance sheets of December 31, 2001, 2002 and 2003 are derived from the Company s audited consolidated financial statements that are not included in this Annual Report.

The consolidated financial statements of the Company are prepared and presented in accordance with IFRS.

With effect from January 1, 2005, in order to comply with IAS1 and IAS27, the Group has changed its accounting policy relating to the presentation of minority interests. In prior years, minority interests at the balance sheet date were presented separately from liabilities and equity in the consolidated balance sheet. Minority interests in the results of the Group for the year were also separately presented in the consolidated statements of operations as a deduction before arriving at the profit attributable to shareholders (the equity shareholders of the Company). Under the new policy, minority interests are presented as part of equity, separately from interests attributable to the equity shareholders of the Company. Minority interests in the results of the Group for the period are presented on the face of the consolidated statements of operations as an allocation of the total profit or loss for the period between the minority interests and the equity shareholders of the Company. These changes in presentation have been applied retrospectively with comparatives restated.

In addition, with effect from January 1, 2005, the Group has changed its presentation of shares of affiliated companies and jointly controlled entities taxation in order to comply with IAS 1. In prior years, the Group s share of taxation of affiliated companies and jointly controlled entities accounted for using the equity method was included as part of the Group s income tax in the consolidated statements of operations. In accordance with the implementation guidance in IAS 1, the Group has changed the presentation and includes the share of taxation of affiliated companies and jointly controlled entities accounted for using the equity method in the respective shares of profit or loss reported in the consolidated statements of operations before arriving at the Group s profit or loss before tax. These changes in presentation have been applied retrospectively with comparatives restated.

Under IFRS, the purchase method of accounting was applied to account for the acquisition of the airline operations and certain related assets of China Northern Airlines Company (CNA) and Xinjiang Airlines Company (XJA) (CNA/XJA Acquisitions) (details of which are disclosed in Item 4. Information on the Company History and Development of the Company) such that at December 31, 2004 only the acquired assets and liabilities are included inthe consolidated financial statements. The results of the acquired operations and their related cash flows was included in the consolidated financial statements of the Group beginning January 1, 2005. Under U.S. GAAP, such transaction is considered to be a combination of entities under common control . A combination of entities under common control is accounted for in a manner similar to a pooling-of-interests . Consequently, the assets and liabilities of CNA and XJA are reflected at their U.S. GAAP carrying values and the U.S. GAAP consolidated financial statements are restated to include the assets and liabilities of CNA and XJA, and their results of operations and cash flows for all periods presented. See Note 50 to the consolidated financial statements for the nature and effect of such differences and other significant differences related to the Group between IFRS and U.S. GAAP as of December 31, 2004 and 2005 and for each of the years in the three-year period ended December 31, 2005 and the condensed consolidated financial statements prepared and presented in accordance with U.S. GAAP for the relevant periods. The following information should be read in conjunction with, and is qualified in its entirety by, the Financial Statements of the Group.

	Year ended December 31,					
	2001	**2002**	**2003**	**2004**	**2005**	**2005**
	RMB	**RMB**	**RMB**	**RMB**	**RMB**	**US$**
	(in million, except per share data)					
Income Statement Data:						
IFRS:	**(Restated)**	**(Restated)**	**(Restated)**	**(Restated)**		
Operating revenue	16,880	18,019	17,470	23,974	38,293	4,745
Operating expenses	15,479	15,993	17,014	23,065	39,598	4,907
Operating income/(loss)	1,401	2,026	456	909	(1,305)	(162)
Interest expense	(934)	(959)	(824)	(691)	(1,616)	(200)
Exchange gain/(loss), net	297	(176)	(164)	(59)	1,220	151
Income/(loss) before taxation	788	1,130	(521)	220	(1,853)	(230)
Taxation (expense)/benefit	(313)	(389)	334	(65)	7	1
Income/ (loss) for the year	475	741	(187)	155	(1,846)	(229)
Income/(loss) attributable to :						
Equity shareholders of the Company	340	576	(358)	(48)	(1,848)	(229)
Minority interests	135	165	171	203	2	
Basic earnings/(loss) per share	0.10	0.17	(0.09)	(0.01)	(0.42)	(0.052)
Basic earnings/(loss) per ADS	5.04	8.53	(4.68)	(0.55)	(21.12)	(2.62)

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	Year ended December 31,					
	2001	**2002**	**2003**	**2004**	**2005**	**2005**
	RMB	**RMB**	**RMB**	**RMB**	**RMB**	**US$**
	(in million, except per share data)					
Cash dividends declared per share		0.02				
U.S. GAAP:						
Traffic revenue	23,615	24,854	24,897	33,235	37,419	4,637
Other operating revenue	657	904	586	930	874	108
Operating income/(loss)	1,584	1,948	366	1,877	(1,092)	(135)
Interest expense	(1,800)	(1,820)	(1,604)	(1,184)	(1,589)	(197)
Foreign currency exchange gain/(loss), net	532	(327)	(381)	(124)	1,220	151
Income/(loss) before income taxes and minority interests	468	(145)	(1,549)	693	(1,574)	(193)
Income tax (expense)/benefit	(401)	(356)	536	(261)	46	4
Minority interests	(97)	(154)	(127)	(193)	(2)	
Net (loss)/income	(30)	(655)	(1,140)	239	(1,530)	(189)
Basic (loss)/earnings per share	(0.009)	(0.194)	(0.298)	0.055	(0.350)	(0.043)
Basic (loss)/earnings per ADS	(0.432)	(9.706)	(14.876)	2.732	(17.489)	(2.172)
Cash dividend declared per share		0.02				

	December 31,					
	2001	**2002**	**2003**	**2004**	**2005**	**2005**
	RMB	**RMB**	**RMB**	**RMB**	**RMB**	**US$**
	(in million)					
Balance Sheet Data:						
IFRS:	**(Restated)**	**(Restated)**	**(Restated)**	**(Restated)**		
Cash and cash equivalents	2,818	3,771	2,080	3,083	2,901	360
Other current assets	1,561	1,835	1,922	4,286	4,320	535
Property, plant and equipment, net	22,352	26,921	28,536	46,841	54,266	6,725
Total assets	30,653	37,188	39,062	62,383	71,402	8,848
Notes payable, including current installments of long term notes payable	2,178	5,241	7,097	11,518	16,223	2,010
Current installments of obligations under capital leases	1,452	1,567	1,298	2,144	3,373	418
Notes payable, excluding current installments	3,628	5,835	4,522	11,935	12,740	1,579
Obligations under capital leases, excluding current installments	7,692	6,632	5,543	9,599	12,459	1,544
Total equity	10,600	11,130	13,569	13,903	11,936	1,479
U.S. GAAP:						
Cash and cash equivalents	4,384	4,772	2,999	3,083	2,901	360
Other current assets	3,065	3,391	3,034	4,505	4,551	561
Property, plant and equipment, net	35,676	40,277	41,012	46,202	53,759	6,662
Total assets	48,456	54,860	58,610	65,144	74,906	9,283
Notes payable, including current portion of long term notes payable	5,359	10,304	8,600	11,518	16,223	2,010

Current installments of obligations under capital leases	2,428	2,591	2,368	2,106	3,401	421
Notes payable, excluding current portion	8,856	9,179	8,634	11,935	12,740	1,579
Obligations under capital leases, excluding current installments	14,167	13,333	13,849	11,975	14,807	1,835
Net shareholders equity	7,315	6,796	13,098	11,169	9,639	1,194

Selected Operating Data

The following selected operating data of the Group for the five years ended December 31, 2005 have been derived from consolidated financial statements prepared in accordance with IFRS and other data provided by the Group and have not been audited.

The operating data and the profit analysis and comparison for other years below is calculated and disclosed in accordance with the statistical standards, which has been implemented since January 1, 2001. See Glossary of Airline Industry Terms at the front of this Annual Report for definitions of certain terms used herein.

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	Year ended December 31,				
	2001	2002	2003	2004	2005
Capacity					
ASK (million)					
Domestic	31,393	33,753	32,590	41,330	72,107
Hong Kong and Macau	1,690	1,746	1,347	1,896	2,656
International	6,981	8,746	6,930	10,543	13,598
Total	40,064	44,245	40,867	53,769	88,361
ATK (million)					
Domestic	3,622	3,924	3,772	4,773	8,352
Hong Kong and Macau	185	193	150	211	315
International	1,317	1,798	1,999	2,462	2,842
Total	5,124	5,915	5,921	7,446	11,509
Kilometers flown (thousand)	234,051	258,379	249,068	324,827	539,844
Hours flown (thousand)	365	405	385	501	846
Number of landing and take-offs					
Domestic	183,651	194,776	191,460	243,410	394,069
Hong Kong and Macau	13,712	13,891	11,400	15,380	17,807
International	10,698	13,990	11,330	15,790	26,798
Total	208,061	222,657	214,190	274,580	438,674
Traffic					
RPK (million)					
Domestic	19,447	22,092	21,294	29,121	51,472
Hong Kong and Macau	1,060	1,081	778	1,203	1,549
International	4,550	5,767	4,315	6,872	8,902
Total	25,057	28,940	26,387	37,196	61,923
RTK (million)					
Domestic	2,217	2,532	2,424	3,206	5,571
Hong Kong and Macau	105	108	78	120	159
International	712	974	1,059	1,337	1,554
Total	3,034	3,614	3,561	4,663	7,284
Passengers carried (thousand)					
Domestic	16,499	18,535	18,259	25,002	39,545
Hong Kong and Macau	1,409	1,369	1,019	1,394	1,556
International	1,213	1,589	1,192	1,811	3,018
Total	19,121	21,493	20,470	28,207	44,119
Cargo and mail carried (tons)	398,000	470,000	464,000	545,000	775,000
Load Factors					
Passenger load factor (RPK/ASK) (%)					
Domestic	61.9	65.5	65.3	70.5	71.4
Hong Kong and Macau	62.7	61.9	57.8	63.4	58.3
International	65.2	65.9	62.3	65.2	65.5
Total	62.5	65.4	64.6	69.2	70.1
Overall load factor (RTK/ATK) (%)					
Domestic	61.2	64.5	64.2	67.2	66.7
Hong Kong and Macau	56.8	55.8	52.2	56.9	50.4

International	54.1	54.2	53.0	54.3	54.7
Total	59.2	61.1	60.1	62.6	63.3
Breakeven load factor (%)	55.6	55.9	61.6	61.9	67.0

	Year ended December 31,				
	2001	**2002**	**2003**	**2004**	**2005**
Yield					
Yield per RPK (RMB)					
Domestic	0.62	0.55	0.57	0.58	0.55
Hong Kong and Macau	1.06	0.98	0.96	0.92	0.77
International	0.41	0.42	0.47	0.46	0.56
Total	0.60	0.54	0.57	0.57	0.55
Yield per cargo and mail ton kilometers (RMB)	1.76	1.73	1.62	1.67	1.75

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	Year ended December 31,				
	2001	**2002**	**2003**	**2004**	**2005**
Yield per RTK (RMB)					
Domestic	5.83	5.21	5.40	5.53	5.30
Hong Kong and Macau	11.26	10.36	10.35	9.83	8.18
International	3.31	3.25	2.90	3.31	4.24
Total	5.43	4.84	4.76	5.01	5.14
Fleet					
Boeing	91	102	108	137	140
Airbus	20	20	24	46	71
McDonnell Douglas				35	36
Others				13	14
Total aircraft in service at period end	111	122	132	231	261
Overall utilization rate (hours per day)	9.1	9.8	8.5	9.9	9.6
Financial					
Operating cost per ASK (RMB)	0.39	0.36	0.42	0.43	0.45
Operating cost per ATK (RMB)	3.02	2.70	2.87	3.10	3.44

Exchange Rate Information

The following table sets forth certain information concerning exchange rates, based on the noon buying rates in New York City for cable transfers in foreign currencies, as certified for customs purposes by the Federal Reserve Bank of New York (the Noon Buying Rate), between Renminbi and U.S. dollars for the five most recent financial years.

Period	**Period End**	**Average(1) (RMB per US$)**	**High**	**Low**
Annual Exchange Rate				
2001	8.2766	8.2766	8.2910	8.2642
2002	8.2773	8.2773	8.2897	8.2152
2003	8.2767	8.2772	8.2800	8.2769
2004	8.2765	8.2765	8.2889	8.2641
2005	8.0694	8.1825	8.2767	8.0702

The following table sets out the range of high and low exchange rates, based on the Noon Buying Rate, between Renminbi and U.S. dollars, for the following periods.

Period	**High**	**Low**
Monthly Exchange Rate		
December 2005	8.0808	8.0702
January 2006	8.0702	8.0601
February 2006	8.0616	8.0402
March 2006	8.0505	8.0172
April 2006	8.0240	8.0050
May 2006	8.0265	8.0025
June 2006 (up to June 28, 2006)	8.0230	7.9964

(1) Determined by averaging the rates on the last

business day of each month during the relevant period.

Dividend Payments

No interim dividends were paid during the year ended December 31, 2005. The Board of Directors of the Company (Board of Directors) has not recommended payment of a final dividend in respect of the year ended December 31, 2005.

Capitalization and Indebtedness

Not applicable.

Reasons for the Offer and Use of Proceeds

Not applicable.

Risk Factors

Risks Relating to the Company

Government ownership and control of the Company

All Chinese airlines are wholly- or majority-owned either by the Chinese Government or by provincial or municipal governments in China. CSAHC, an entity wholly-owned by the Chinese Government, holds and exercises the rights of ownership of all of the Domestic Shares or 50.3% of the equity of the Company. The interests of the Chinese Government in the Company and in other Chinese airlines may conflict with the interests of the holders of the ADSs, H Shares and A Shares. The public policy considerations of the Chinese Government in regulating the Chinese commercial aviation industry may also conflict with its indirect ownership interest in the Company.

High operating leverage and foreign exchange exposure

The airline industry is generally characterized by a high degree of operating leverage. In addition, due to high fixed costs, the expenses relating to the operation of any flight do not vary proportionately with the number of passengers carried, while revenues generated from a flight are directly related to the number of passengers carried and the fare structure of such flight. Accordingly, a decrease in revenues could result in a proportionately higher decrease in net income. Moreover, as the Group has substantial obligations denominated in foreign currencies, its results of operations are significantly affected by fluctuations in foreign exchange rates, particularly for the U.S. dollar and the Japanese Yen. The Company incurred a net exchange loss of RMB59 million for 2004 and a net exchange gain of RMB1,220 million for 2005, mainly as a result of Japanese Yen fluctuation in 2004 and Renminbi appreciation in July 2005, respectively. A majority of this exchange loss or gain was unrealized in nature.

Potential conflicts of interest

CSAHC will continue to be the controlling shareholder of the Company. CSAHC and certain of its affiliated companies will continue to provide certain important services to the Company, including the import and export of aircraft spare parts and other flight equipment, housing services and financial services. In addition, Mr. Liu Shao Yong, the Chairman of the Board of Directors, also serves as the General Manager of CSAHC. The interests of CSAHC may conflict with those of the Company. In addition, any disruption of the provision of services by CSAHC s affiliated companies or a default by CSAHC of its obligations owed to the Company could affect the Company s operations and financial conditions. In particular, as part of its cash management system, the Company periodically places significant amount of demand deposits with China Southern Airlines Group Finance Company Limited (SA Finance), a PRC authorized financial institution controlled by CSAHC and an affiliated company of the Company. As a result, the Company s deposits with SA Finance are subject to the risks associated with the business of SA Finance over which the Company does not exercise control. As of December 31, 2004 and 2005, the Group had short-term deposits of RMB406 million and RMB544 million, respectively, with SA Finance.

Certain transactions between the Company and CSAHC or its affiliates (as defined in the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited (the Hong Kong Listing Rules)) will constitute connected transactions of the Company under the Hong Kong Listing Rules and, unless exemptions are applicable or waivers are granted, will be subject to disclosure requirements and/or independent shareholders approval in a general meeting.

Risks relating to certain real property

Although systems for registration and transfer of land use rights and related real property interests in China have been implemented, such systems do not yet comprehensively account for all land and related property interests. The land in Guangzhou on which the Company s headquarters buildings and other facilities are located and the buildings that the Company uses at its route base in Wuhan and Haikou are leased by the Company from CSAHC. However, CSAHC lacks adequate documentation evidencing CSAHC s rights to such land and buildings, and, as a consequence, the lease agreements between CSAHC and the Company for such land have not been registered with the relevant authorities. As a result, such lease agreements may not be enforceable. Lack of adequate documentation for land use rights and ownership of buildings subjects the Company to challenges and claims by third parties with respect to the Company s use of such land and buildings.

The Company has been occupying all of the land and buildings described above without challenge or claim by third parties. CSAHC has received written assurance from the General Administration of Civil Aviation of China (CAAC) to the effect that CSAHC is entitled to continued use and occupancy of the land and certain related buildings and facilities. However, such assurance does not constitute formal evidence of CSAHC s right to occupy such lands, buildings and facilities, or the right to transfer, mortgage or lease such real property interests. The Company cannot predict the magnitude of the adverse effect on its operations if its use of any one or more of these parcels of land or buildings were successfully challenged. CSAHC has agreed to indemnify the Company and Guangzhou Aircraft Maintenance Engineering Company Limited (GAMECO), the Company s jointly controlled entity, against any loss or damage caused by any challenge of, or interference with, the use by the Company and GAMECO of any of their respective land and buildings.

Risks associated with Hong Kong and Macau routes

The Company s Hong Kong regional routes benefit from traffic originating in Taiwan. The Company s Hong Kong regional routes might be materially adversely affected if direct flights between Taiwan and Mainland China were permitted in the future. In such event, Xiamen Airlines Company Limited (Xiamen Airlines), the Company s subsidiary, might apply for route rights for direct flights between Taiwan and Mainland China, due partly to the proximity to Taiwan of Fujian province, where Xiamen Airlines is based. However, there can be no assurance that sufficient routes and flights between destinations in Taiwan and Mainland China could be obtained by Xiamen Airlines, if at all, or that adequate yields will be generated on these routes and flights.

Internal controls and management system

The Company will become subject to Section 404 of the Sarbanes-Oxley Act of 2002 in the fiscal year ending December 31, 2006, which requires the Company to set out a management report containing an assessment on its internal controls over financial reporting in its annual report. It also requires an independent registered public accounting firm attest to and report on management s assessment of the effectiveness of the Company s internal controls over financial reporting. If the Company cannot implement the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 in a timely manner or with adequate compliance, its independent auditors may not be able to provide a written attestation as to the effectiveness of its internal controls over financial reporting and it may be subject to sanctions or investigation by regulatory authorities, such as the Securities and Exchange Commission. It could also result in the loss of investor confidence in the Company, in particular the reliability of financial statements, which in turn could harm the Company s business and negatively affect the market price of the Company s ADSs or H Shares. Furthermore, the Company may be required to incur significant costs for compliance with Section 404, and thereby increasing its costs relative to its revenues and decreasing its operating margins.

Risks Relating to the Chinese Commercial Aviation Industry

Government regulation

The Company s ability to implement its business strategy will continue to be affected by regulations and policies issued or implemented by the CAAC, which encompasses substantially all aspects of the Chinese commercial aviation industry, including the approval of domestic, Hong Kong regional and international route allocation, air fares, aircraft acquisition, jet fuel prices and standards for aircraft maintenance, airport operations and air traffic control. Such regulations and policies limit the flexibility of the Company to respond to market conditions, competition or changes in the Company s cost structure. The implementation of specific CAAC policies could from time to time adversely affect the Company s operations. The CAAC has confirmed in writing that the Company will be treated equally with other Chinese airlines with respect to certain matters regulated by the CAAC. Nevertheless, there can be no assurance that the CAAC will, in all circumstances, apply its regulations and policies in a manner that results in equal treatment of all airlines.

Jet fuel supply and costs

The availability and cost of jet fuel have a significant impact on the Group s results of operations. The Group s jet fuel costs for 2005 accounted for 30.1% of its operating expenses. All of the domestic jet fuel requirements of Chinese airlines (other than at the Shenzhen, Zhuhai and Sanya airports) must be purchased from the exclusive providers, China Aviation Oil Supplies Company (CAOSC) and Bluesky Oil Supplies Company, companies controlled and supervised by the CAAC. Chinese airlines may also purchase their jet fuel requirements at the Shenzhen, Zhuhai and

Sanya airports from joint ventures in which the CAOSC is a partner. Jet fuel obtained from the CAOSC s regional branches is purchased at uniform prices throughout China that are determined and adjusted by the CAOSC from time to time with the approval of the CAAC and the pricing department of the State Planning Commission based on market conditions and other factors. As a result, the costs of transportation and storage of jet fuel in all regions of China are spread among all domestic airlines. Prior to 1994, domestic jet fuel prices were generally below international jet fuel prices. Since then, however, domestic jet fuel price from CAOSC has always been higher than international jet fuel prices, sometimes creating tension in fuel supply. In addition, jet fuel shortages have occurred in China and, on limited occasions before 1993, required the Company to delay or cancel flights. Although such shortages have not materially affected the Company s results of operations since 1993, there can be no assurance that such shortage will not occur in the future. If such shortage occurs in the future and the Company is forced to delay or cancel flights due to fuel shortage, its operational reputation among passengers and results of operations may suffer.

Infrastructure limitations

The rapid increase in air traffic volume in China in recent years has put pressure on many components of the Chinese commercial aviation industry, including China s air traffic control system, the availability of qualified flight personnel and airport facilities. Airlines, such as the Company, which have route networks that emphasize short- to medium-haul routes are generally more affected by insufficient aviation infrastructure in terms of on-time performance and high operating costs due to fuel inefficiencies resulting from the relatively short segments flown, as well as the relatively high proportion of time on the ground during turnaround. All of these factors may adversely affect the perception of the service provided by an airline and, consequently, the airline s operating results. In recent years, the CAAC has placed increasing emphasis on the safety of Chinese airline operations and has implemented measures aimed at improving the safety record of the industry. The ability of the Company to increase utilization rates and to provide safe and efficient air transportation in the future will depend in part on factors such as the improvement of national air traffic control and navigation systems and ground control operations at Chinese airports, which factors are beyond the control of the Company.

Competition

The CAAC s extensive regulation of the Chinese commercial aviation industry has had the effect of managing competition among Chinese airlines. Nevertheless, competition has become increasingly intense in recent years due to a number of factors, including relaxation of certain regulations by the CAAC, and an increase in the capacity, routes and flights of Chinese airlines. Competition in the Chinese commercial aviation industry has led to widespread price-cutting practices that do not in all respects comply with applicable regulations. Until the interpretation, if it occurs, of CAAC regulations limiting or prohibiting such price-cutting has been finalized and strictly enforced, discounted tickets from competitors will continue to have an adverse effect on the Company s sales.

The Company faces varying degrees of competition on its Hong Kong regional routes from certain Chinese airlines and Hong Kong Dragon Airlines Limited and on its international routes, primarily from non-Chinese airlines, most of which have significantly longer operating histories, substantially greater financial and technological resources and greater name recognition than the Company. In addition, the public s perception of the safety and service records of Chinese airlines could adversely affect the Company s ability to compete against its Hong Kong regional and international competitors. Many of the Company s international competitors have larger sales networks and participate in reservation systems that are more comprehensive and convenient than those of the Company, or engage in promotional activities, such as International Alliance programs, that may enhance their ability to attract international passengers.

Limitation on foreign ownership

Chinese Government policies limit foreign ownership in Chinese airlines. Under these policies, the percentage ownership of the Company s total outstanding ordinary shares held by investors in Hong Kong and any country outside China (Foreign Investors) may not in the aggregate exceed 49%. Currently, 26.8% of the total outstanding ordinary shares of the Company is held by Foreign Investors. For so long as the limitation on foreign ownership is in force, the Company will have no meaningful access to the international equity capital markets.

Consolidation and Restructuring

In 2000, the CAAC announced a restructuring plan with respect to the PRC aviation industry. Pursuant to such restructuring plan, each domestic airline is directed to consolidate into one of the three major airline groups in China: CSAHC, China National Aviation Holding Company and China Eastern Air Holding Group. As approved by the Company s shareholders in an extraordinary general meeting on December 31, 2004, the Company acquired the airline operations and certain related assets of CNA and XJA. These consolidation and restructuring pursuant to the CAAC restructuring plan may involve uncertainties and risks over a long period of time, including the following:

- failure to achieve the anticipated synergies, cost savings or revenue enhancing opportunities resulting from the restructuring activities;

- diversion of management s attention from existing business concerns and other business opportunities of the Group;

- difficulty in integrating the assets and business of other airlines, including its employees, corporate culture, managerial systems and processes, business information systems and services;

- difficulty in exercising control and supervision over various new operations within the Group;

failure to retain key personnel; and

increase in financial pressure due to assumption of recorded / unrecorded liabilities of the acquired businesses.

The inability to manage additional businesses or integrate successfully the acquired businesses without substantial expense, delay or other operational or financial problems, or the occurrence of one or more of the events enumerated above, could materially adversely affect the Group s financial condition and results of operations.

Risks relating to the PRC

Foreign exchange risks

Under current Chinese foreign exchange regulations, Renminbi is fully convertible for current account transactions, but is not freely convertible for capital account transactions. Current account foreign exchange transactions can be undertaken without prior approval from the relevant Chinese Government agencies by producing commercial documents evidencing such transactions, provided that they are processed through Chinese banks licensed to engage in foreign exchange transactions. Conversion from Renminbi into a foreign currency or vice versa for purposes of capital account transactions requires prior approvals of relevant Chinese Government agencies. This restriction on capital account transactions could affect the ability of the Company to acquire foreign currency for capital expenditures. It could also have a material adverse effect on the Company's operations and financial conditions, given the Company's substantial foreign currency obligations.

The value of the Renminbi against the US dollar and other foreign currencies may fluctuate and is affected by, among other things, changes in China's political and economic conditions. On July 21, 2005, the PRC government changed its policy of pegging the value of the Renminbi to the U.S. dollar so that the Renminbi is now permitted to fluctuate within a band against a basket of certain foreign currencies. As a result, the value of the Renminbi against the U.S. dollar has appreciated by approximately 2%. Under the new policy, the value of Renminbi against the U.S. dollar has fluctuated on a daily basis within narrow ranges, but overall has further strengthened against the U.S. dollar. The PRC government has stated publicly that it intends to further liberalize its currency policy, which could result in a further and more significant change in the value of the Renminbi against the U.S. dollar. As the Company is not able to hedge effectively against the revaluation of the Reminbi other than by retaining its foreign currencies which it receives from its business and operational activities to the extent permitted by applicable law, any significant revaluation of the Renminbi may have a material adverse effect on the Company's financial performance, and the value of, and any dividends payable on, the Company's H Shares and ADSs in foreign currency terms.

Developing legal system

The Chinese legal system is based on written statutes and is a system, unlike common law systems, in which decided legal cases have little precedential value. In 1979, China began to promulgate a more comprehensive system of laws. On December 29, 1993, the Chinese National People s Congress promulgated the Company Law, which became effective on July 1, 1994. In August 1994, pursuant to the Company Law, the PRC State Council issued the PRC Special Regulations on Overseas Offering and Listing of Shares by Companies Limited by Shares to regulate joint stock companies that offer and list their shares overseas. These laws, regulations and legal requirements are relatively recent, and, like other laws, regulations and legal requirements applicable in China (including with respect to the commercial aviation industry), their interpretation and enforcement involve significant uncertainties.

Taxation of holders of H Shares or ADS by China

Chinese tax law generally provides for the imposition of a withholding tax on dividends paid by a Chinese company to a non-Chinese shareholder at a rate of 20%. In a notice and a letter issued by the State Taxation Bureau of the PRC, however, the Chinese tax authorities confirmed that the imposition of this withholding tax on dividends paid by joint stock companies, such as the Company, had been suspended. Accordingly, for so long as this imposition is suspended and not replaced or supplemented with similar requirements, any future dividends to be paid by the Company to holders of H Shares or ADS who are foreign individuals not resident in China or which are foreign enterprises with no permanent establishment in China will not be subject to a Chinese withholding tax. In the event that the suspension of the withholding tax is lifted, such payments will be subject to withholding tax at the 20% rate unless the holder is entitled to a tax waiver or a lower tax rate under an applicable double-taxation treaty. See Item 10 Additional Information Taxation .

ITEM 4. INFORMATION ON THE COMPANY.

History and Development of the Company

The Company is a joint stock company incorporated in China on March 25, 1995, and is 50.3% owned by CSAHC. The registered address of the Company is Guangzhou Economic & Technology Development Zone, People s Republic of China (telephone no: (86)20-8612-4738, website: www.cs-air.com).

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On March 13, 2003, the Company obtained an approval certificate from the Ministry of Commerce to change to a permanent limited company with foreign investments and on October 17, 2003 obtained a business license for its new status, as a permanent limited company with foreign investments issued by the State Administration of Industry and Commerce of the People s Republic of China.

Pursuant to an extraordinary general meeting of shareholders held on May 21, 2002, a resolution was passed authorizing the Company to issue not more than 1,000,000,000 A Shares of par value of RMB1.00 each. The Company issued and listed its 1,000,000,000 A Shares with a par value of RMB1.00 each on the Shanghai Stock Exchange in July 2003.

On October 17, 2003, the Company s registered address was moved to Guangzhou Economic & Technology Development Zone. In accordance with the Rules and Regulations for Implementation of Income Tax for Foreign Investment Enterprises and Foreign Enterprises of the PRC and a taxation approval document Guangzhou Municipal State Tax Bureau Suo De Shui Zi Que 020043 , the Company is entitled to enjoy the preferential tax policy implemented in the Guangzhou Economic & Technology Development Zone effective October 1, 2003. As a result, the Company s income tax rate has been changed from 33% to 15% beginning from that date.

Flight safety is a perennial concern to airlines. In this regard, the Group is committed to flight safety by strengthening internal safety checks, pilot training and aircraft maintenance. As a result, the Group was awarded the Golden Roc Cup, the highest award for flight safety in the Chinese civil aviation industry, for the fourth time in 2004.

The acquisition of the airline operations of CNA and XJA was approved at the general meeting of the Company held on December 31, 2004. Such acquisition provides a robust platform for the Group to consolidate its market leadership and financial results. It also brought in various benefits to the Group by expanding its flight service network, fleet size and transport capacity, as well as lowering costs and improving overall efficiency. Given the investment incentive policies such as Go West and Revitalising the Old Industrial Bases in the North-eastern Region promulgated by the Chinese government, the economy in the western and north-eastern regions of China is expected to grow at a rapid pace in the coming decades, which in turn provides substantial growth potential for the Group. Ultimately, the acquisition will strengthen the Group s position as the largest airline in China and will create positive value to its investors. At present, the management of the Group focuses on harnessing the expanded business capacity and operation scale of the Group, and on enhancing its overall management standards through an integration of corporate culture, innovation and development, thereby realizing the ultimate goal of the Group s reorganization.

Pursuant to Pricing Reform of Domestic Civil Aviation as approved by the State Council of China effective on April 20, 2004, prices on domestic routes now fluctuate freely within a predetermined range. Instead of direct supervision by setting prices of air tickets through local price bureau, the government now provides guidance on domestic flights and domestic civil aviation is controlled by the government indirectly. Market-oriented pricing policy was introduced and pricing system has been adjusted as a result of the above pricing reform.

During 2005, the economy of the PRC maintained its rapid growth, which in turn gave the civil aviation industry a powerful boost. In particular, the fast expansion of the fleet capacity of the industry encouraged market demand through a number of factors, including improvement of civil aviation facilities and service quality as well as favorable price offers, which in turn drove up the passenger and cargo carried volume, the passenger load factor and overall load factor. On the other hand, as the PRC government expedited the process of open sky policy and relaxed restrictions for investment in domestic airlines, the fleet capacity and number of flights provided have significantly increased, which in turn intensified the competition in domestic and international routes. Together with the soaring jet fuel prices, these have exerted strong pressure on the operating costs for domestic airlines.

In 2005, with the persistent joint efforts of the Company s management and staff, the Group secured an exceptional safe flight operation record, and the enlarged operations after the joint recombination had undergone a smooth transition and gradually began to achieve the benefits from economies of scale. To cope with the increasing competition and the ever-changing demands of the aviation market, the Company is taking advantage of its own economies of scale and the potential market demands to stage a strategic transition from a city-pair operation model to a hubbing network operation model, so as to enhance the operational efficiency of the overall service network, and to maintain and increase its competitive edge in the market.

With the approval of the Board, the Company established a branch company in Beijing and will add wide-body airplanes to the operation base in Beijing from the summer of 2006, with the view to expanding its Beijing aviation business and building another main hub there in addition to its Guangzhou base. The Board believes that the establishment of Guangzhou and Beijing hubs will facilitate the Group s strategic refinement and enhancement of its route network operations in order to better position the Group to explore and seize the opportunities in the regional aviation market to be brought about by the 2008 Beijing Olympic Games.

The Group had RMB4,707 million, RMB6,631 million and RMB11,873 million capital expenditures in 2003, 2004 and 2005 respectively. Of such capital expenditures in 2005, RMB6,938 were financed by capital lease, RMB4,325 million were financed by bank borrowings while the remaining RMB610 million were financed by internal resources. The capital expenditures were primarily incurred on the additional investments in aircraft and flight equipment under the Group s fleet expansion plans and Guangzhou new airport, and, to a small extent, additional investments in other facilities and buildings for operations.

CNA/XJA Acquisitions

Pursuant to a sale and purchase agreement dated November 12, 2004 between the Company, China Southern Airlines Holding Company, CNA and XJA which was approved by the Company s shareholders in an extraordinary general meeting held on December 31, 2004, the Company acquired the airline operations and certain related assets of CNA and XJA with effect from December 31, 2004 (the CNA/XJA Acquisitions). The consideration payable for the CNA/XJA Acquisitions amounting to RMB15,522 million was determined based on the fair value of the acquired assets. Such consideration was partly satisfied by assumption of debts and liabilities of CNA and XJA totaling RMB13,563 million outstanding as of December 31, 2004 and the remaining balance of RMB1,959 million was fully paid in cash during 2005.

The CNA/XJA Acquisitions have significantly expanded the fleet size and flight service network as well as the market share of the Group. Presently, the Group is implementing various measures to harnessing the expanded flight capacity and operations and integrating the business cultures and goals of the acquired operations with those of the Group.

Business Overview

General

The Group provides commercial airline services throughout China, Hong Kong and Macau regions, Southeast Asia and other parts of the world. The Group is one of the three largest Chinese airlines and, as of year end 2005, ranked first in terms of passengers carried, number of scheduled flights per week, number of hours flown and size of route network and aircraft fleet. During the three years ended December 31, 2005, the Group s RPKs increased at a compound annual rate of 53.2%, from 26,387 million in 2003 to 61,923 million in 2005, while its capacity, measured in terms of ASKs, increased at a compound annual rate of 47.1%, from 40,867 million in 2003 to 88,361 million in 2005. In 2005, the Group carried 44.12 million passengers and had passenger revenue of RMB34,328 million (US$4,254 million). The loss for 2005 attributable to equity shareholders of the Company was RMB1,848 million (US$229 million).

The Group conducts a portion of its airline operations through its airline subsidiaries namely Xiamen Airlines, Southern Airlines (Group) Shantou Airlines Company Limited (Shantou Airlines), Guangxi Airlines Company Limited (Guangxi Airlines), Zhuhai Airlines Company Limited (Zhuhai Airlines) and Guizhou Airlines Company Limited (Guizhou Airlines) (collectively, the Airline Subsidiaries). In 2005, the Airline Subsidiaries carried 11.30 million passengers and had operating revenue of RMB8,019 million (US$994 million) and accounted for 25.6% and 20.9% of the Group s passengers carried and operating revenue, respectively.

The Group also provides air cargo and mail services. The cargo and mail revenue of the Group increased by 37.7% to RMB3,091 million (US$383 million) in 2005 as compared with 2004. The Group s airline operations are fully integrated with its airline-related businesses, including aircraft and engine maintenance, flight simulation and air catering operations.

As of the year end of 2005, the Group operated 559 routes, of which 452 were domestic, 78 were international and 29 were Hong Kong and Macau. The Group operates the most extensive domestic route network among all Chinese airlines. In 2005, the Group operated an average of 8,436 landings and take-offs per week, serving 142 destinations. Its route network covers commercial centres or rapidly developing economic regions in Mainland China.

The Group s corporate headquarters and principal base of operations are located in Guangzhou, which is the capital of Guangdong Province and the largest city in southern China. Located in the rapidly developing Pearl River Delta region, Guangzhou is also the transportation hub of southern China and one of China s major gateway cities. Guangzhou s significance has increased as the transportation infrastructure of Guangdong Province has developed through the construction and development of expressways, an extensive rail network and the port cities of Yantian, Shekou, Chiwan, Mawan, Huangpu and Zhuhai.

In addition to its main route base in Guangzhou, the Group also maintains certain regional route bases in Beijing, Zhengzhou, Wuhan, Changsha, Shenzhen, Shenyang, Changchun, Dalian, Harbin, Urumqi, Haikou, Zhuhai, Xiamen, Fuzhou, Guilin, Shantou, Guiyang, Sanya and Beihai. Most of its regional route bases are located in provincial capitals or major commercial centers in China.

The Group s operations primarily focus on the domestic market. In addition, the Group also operates Hong Kong and Macau and international flights. As of year end of 2005, the Group had 29 Hong Kong and Macau routes and 78 international routes. The Group s Hong Kong and Macau operations include flights between destinations in China and Hong Kong and Macau. The Group s international operations include scheduled services to Tokyo, Osaka, Amsterdam, Sharjah, Los Angeles, Fukuoka, Seoul, Sydney, Dubai, Paris and 11 Southeast Asian destinations. The Group operates the most extensive Southeast Asian route network among Chinese airlines.

As of December 31, 2005, the Group operated a fleet of 261 aircraft, consisting primarily of Boeing 737 series, 747, 757, 777, Airbus 300, 319, 320, 330, McDonnell Douglas 82, 90 and etc. The average age of the Group s fleet was 7.19 years as of the year end of 2005.

Restructuring and Initial Public Offering

As part of China s economic reforms in the 1980 s, the PRC State Council directed the CAAC to separate its governmental, administrative and regulatory role from the commercial airline operations that were being conducted by the CAAC and its regional administrators. As a result, CSAHC was established on January 26, 1991 for the purpose of assuming the airline and airline-related commercial operations of the Guangzhou Civil Aviation Administration, one of the six regional bureaus of the CAAC. CSAHC was one of the 55 large-scale enterprises designated by the Chinese Government to play a leading role in their respective industries.

CSAHC was restructured in 1994 and 1995 in anticipation of the initial public offering of the Company. The restructuring was effected through the establishment of the Company and the execution of the Demerger Agreement, dated as of March 25, 1995, as amended (the Demerger Agreement), between CSAHC and the Company. Upon the restructuring, the Company assumed substantially all of the airline and airline-related businesses, assets and liabilities of CSAHC, and CSAHC retained its non-airline and non-airline-related businesses, assets and liabilities, and the non-business assets and liabilities. Upon this separation, all interests, rights, duties and obligations of CSAHC, whenever created or accrued, were divided between the Company and CSAHC based on the businesses, assets and liabilities assumed by each of them under the Demerger Agreement. Under the Demerger Agreement, CSAHC agreed not to conduct or participate or hold any interest in, either directly or indirectly, any business, activity or entity in or outside China that competes or is likely to compete with the commercial interests of the Group, although CSAHC may continue to hold and control the affiliates of CSAHC existing on the date of the Demerger Agreement and may continue to operate the businesses of such affiliates.

In July 1997, the Company completed a private placement of 32,200,000 H Shares to certain limited partnership investment funds affiliated with Goldman Sachs & Co. and an initial public offering of 1,141,978,000 H Shares, par value RMB 1.00 per share, and listing of the H Shares on The Stock Exchange of Hong Kong Limited (the Hong Kong Stock Exchange) and American Depositary Shares (ADSs , each ADS representing 50 H Shares) on the New York Stock Exchange. Prior to the private placement and the initial public offering, all of the issued and outstanding shares of capital stock of the Company, consisting of 2,200,000,000 Domestic Shares, par value RMB 1.00 per share, were owned by CSAHC, which owns and exercises, on behalf of the Chinese Government and under the supervision of the CAAC, the rights of ownership of the Domestic Shares held by CSAHC. After giving effect to the private placement and the initial public offering, CSAHC s continued ownership of the 2,200,000,000 Domestic Shares, represented approximately 65.2% of the total share capital of the Company, and will be entitled to elect all the directors of the Company and to control the management and policies of the Group. Domestic Shares and H Shares are both ordinary shares of the Company.

Pursuant to an extraordinary general meeting of shareholders held on May 21, 2002, a resolution was passed authorizing the Company to issue not more than 1,000,000,000 A Shares of par value of RMB1.00 each. The Company issued 1,000,000,000 A Shares with a par value of RMB1.00 each in July 2003 and listed these shares on the Shanghai Stock Exchange. Subsequent to the A Share issue, the shareholding of CSAHC on the Company was reduced from 65.2% to 50.3%.

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Traffic

The following table sets forth certain statistical information with respect to the Group s passenger and cargo and mail traffic for the years indicated.

	Passenger carried		Cargo and Mail Carried (tons)		Total traffic (tons kilometers)	
Year	**Total**	**Increase (decrease) over previous year**	**Total**	**Increase (decrease) over previous year**	**Total**	**Increase (decrease) over previous year**
	(in million)	**(%)**	**(in thousand)**	**(%)**	**(in million)**	**(%)**
2001	19.12	13.5	398.0	12.7	3,034.0	16.1
2002	21.49	12.4	470.0	18.1	3,614.0	19.1
2003	20.47	(4.7)	464.0	(1.3)	3,561.0	(1.5)
2004	28.21	37.8	545.0	17.5	4,663.0	30.9
2005	44.12	56.4	775.0	42.2	7,284.0	56.2

Route Network

Overview

The Group operates the most extensive route network among the Chinese airlines. As of December 31, 2005, the Group operated 559 routes consisting of 452 domestic routes, 29 Hong Kong and Macau routes and 78 international routes. In 2005, the Group conducted an average of 8,436 landings and take-offs per week, serving 142 destinations.

The Group continually evaluates its network of domestic, Hong Kong and Macau and international routes in light of its operating profitability and efficiency. The Group seeks to coordinate flight schedules with the Airline Subsidiaries on shared routes to maximize load factors and utilization rates. The acquisition of domestic, Hong Kong and Macau and international routes is subject to approval of the CAAC, and the acquisition of Hong Kong and Macau and international routes is also subject to the existence and the terms of agreements between the Chinese Government and the government of the Hong Kong SAR, the government of Macau Special Administrative Region of the People s Republic of China (Macau SAR) and the government of the proposed foreign destination.

In order to expand the Group s international route network, the Group has entered into code-sharing agreements with several international airlines, including Delta Airlines, Asiana Airlines, Japan Air System, Vietnam Airlines, Royal Dutch Airlines and Garuda Indonesian. Under the code sharing agreements, the participating airlines are permitted to sell tickets on certain international routes operated by the Group to passengers using the Group s codes. Similarly, the Group is permitted to sell tickets for the other participating airlines using its CZ code. The code sharing agreements help increase the number of the Group s international sales outlets.

Route Bases

In addition to its main route base in Guangzhou, the Group maintains certain regional route bases in Beijing, Zhengzhou, Wuhan, Changsha, Shenzhen, Shenyang, Changchun, Dalian, Harbin, Urumqi, Haikou, Zhuhai, Xiamen, Fuzhou, Guilin, Shantou, Guiyang, Sanya and Beihai. Most of its regional route bases are located in provincial capitals or major commercial centres in the PRC.

The Group believes that its extensive network of route bases enables it to coordinate flights and deploy its aircraft more effectively and to provide more convenient connecting flight schedules and access service and maintenance facilities for its aircraft. The Group believes that the number and location of these route bases may enhance the Group s ability to obtain the CAAC s approval of requests by the Group to open new routes and provide additional flights between these bases and other destinations in China. Current regulations of the CAAC generally limit airlines to operations principally conducted from their respective route bases.

The Chinese Government approved a new Guangzhou airport project, which commenced construction in 2000 and completed in August 2004. The commencement of operation of the new Guangzhou Baiyun International Airport which is the main hub of the Group, provides a wider platform of development for the operations of the Company.

Moreover, the Group has successfully secured the exclusive right to use Terminal No. 1 of the Beijing Capital International Airport, marking a substantial step in carrying out the strategy of the Group to improve its flight routes network.

Domestic Routes

The Group s domestic routes network serves substantially all provinces and autonomous regions in China, including Guangdong, Fujian, Hubei, Hunan, Hainan, Guangxi, Guizhou, Henan, Heilongjiang, Jilin, Liaoning and Xinjiang, and serves all four centrally-administered municipalities in China, namely, Beijing, Shanghai, Tianjin, and Chongqing. In 2005, the Group s most profitable domestic routes were the routes between Guangzhou and Beijing, Guangzhou and Shanghai, Shenzhen and Beijing, Shanghai and Guangzhou, Shenzhen and Shanghai, Beijing and Guangzhou, Urumqi and Beijing, Beijing and Urumqi, Shanghai and Shenzhen, Beijing and Changchun.

Hong Kong and Macau Routes

The Group offers scheduled service between Hong Kong and Guangzhou, Kunming, Xiamen, Shantou, Beijing, Guilin, Meixian, Haikou, Wuhan, Zhengzhou, Nanning, Changsha, Quanzhou and Sanya; and between Macau and Fuzhou, Hangzhou and Xiamen. The Group s Hong Kong regional routes also include routes between Hong Kong and Zhanjiang, which the Group operates on a charter flight basis, as explained below. The Group believes that the routes on which it operates these charter flights are among its highest yielding routes, primarily because the Group faces limited competition on such routes and is consequently less subject to downward pricing pressures. In 2005, the most profitable Hong Kong regional routes (other than these charter flights) were those between Hong Kong and each of Wuhan, Guangzhou, Beijing, Shantou, Guilin, Kunming and Zhengzhou.

The Group s charter flights are regularly scheduled flights, but permission to operate these flights is subject to monthly review by the CAAC and the Civil Aviation Department of the Hong Kong SAR. The CAAC has informally indicated that it primarily considers market demand and airline capability in granting permission for such flights. The Group has been able to maintain all of the Hong Kong regional routes which it operates on a charter flight basis and believes that demand on such routes will continue. In 2005, the Group conducted a total of 17,807 flights on its Hong Kong and Macau routes, accounting for approximately 34.4% of all passengers carried by Chinese airlines on routes between Hong Kong or Macau and destinations in China.

International Routes

The Group is the principal Chinese airline connecting the rapidly developing Pearl River Delta region of China to Southeast Asia, with 29 routes serving 11 Southeast Asian destinations, including Singapore and major cities in Indonesia, Thailand, Malaysia, the Philippines, Vietnam and Laos. In 2005, the Group s most profitable international routes were those between Seoul and Dalian, Guangzhou and Tokyo. The Group believes that, among Chinese airlines, it is well-positioned to benefit from the business opportunities arising out of increased air traffic and the growing economic relationships between China and Southeast Asian countries.

In addition to the 29 routes serving 11 Southeast Asian destinations, the Group operates 45 other international routes providing scheduled services to Amsterdam, Sharjah, Osaka, Tokyo, Fukuoka, Seoul, Los Angeles, Sydney, Melbourne, Dubai and Paris.

Aircraft Fleet

The Group s fleet plan in recent years has emphasized expansion and modernization through the acquisition of new aircraft, the acquisition of existing aircraft in conjunction with our acquisition of CNA and XJA, and the retirement of less efficient, older aircraft. As of December 31, 2005, the Group operated a fleet of 261 aircraft with an average age of 7.19 years. Most aircraft of the Group are Boeing and Airbus aircraft. The Group has the largest fleet among Chinese airline companies. Most of the aircraft operated by the Group are leased pursuant to various types of leasing arrangements.

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The following table sets forth certain information regarding the Group s fleet of 261 aircraft as of December 31, 2005.

Model	Number of Aircraft	Average age (years)	Average Passenger Capacity
Boeing 777-200	4	9.53	380
Boeing 777-21B	6	7.20	292
Boeing 757-200	38	11.12	200
Boeing 747F	2	3.42	n/a
Boeing 737-800	15	2.32	167
Boeing 737-700	29	2.85	138
Boeing 737-500	15	12.80	130
Boeing 737-300	31	11.89	145
Airbus 300-600	6	10.96	272
Airbus 319-100	21	1.05	128
Airbus 320-200	30	5.38	158
Airbus 321-100	10	2.50	182
Airbus 330-200	4	0.72	264
McDonnell Douglas 82	23	14.63	144
McDonnell Douglas 90	13	7.85	157
Embraer 145 Jet	6	1.23	50
Cessna 208B	3	3.50	14
ATR-72	5	7.95	72
	261		

During 2005, the Group continued to expand and modernize its aircraft fleet. In 2005, the Group s major aircraft transactions included:

The addition of seven Airbus 319-100, two Boeing 737-700 and three Boeing 737-800 aircraft under operating lease and addition of one McDonnell Douglas 82 aircraft under wet lease agreement and the return of two Boeing 737-300, three Boeing 737-500 and two Boeing 737-300 QC under operating lease ; and

The acquisition of five Boeing 737-700 aircraft, six Airbus 320-200, four Airbus 330-200, six Airbus 319-100, two Airbus 321-200 and one Embraer 145 Jet financed by a combination of internal funds and long term bank loans.

In January 2005, the Company, as a lessee, entered into an agreement with an independent lessor for operating leases of nine Boeing 737-800 aircraft for a term of seven years with total future lease payments totalling approximately RMB1,721 million, scheduled for deliveries in 2005 and 2006.

In January 2005, China Aviation Supplies Import and Export Corporation, as a sole importing agent, entered into, on behalf of several PRC airlines including the Group, a general purchase agreement with the Boeing Company for the import of Boeing B7E7 aircraft. The Company, being one of the ultimate users for thirteen of the Boeing B7E7 aircraft, endorsed the general purchase agreement. The Company is currently in negotiation with the Boeing Company regarding the purchase agreements on such aircraft.

In March 2005, the Company, as a lessee, entered into another agreement with an independent lessor for operating leases of a total of twenty-five aircraft comprising five Boeing 737-700 aircraft, five Boeing 737-800 aircraft, five Airbus 320-200 aircraft and ten Airbus 321-200 aircraft with scheduled deliveries in 2006 and 2007. The terms of the leases range from ten to twelve years with total future lease payments totalling approximately RMB8,243 million.

In April 2005, the Company entered into a purchase agreement with Airbus SNC for the purchase of five Airbus A380 aircraft, scheduled for deliveries in 2007 to 2010.

In August 2005, CSA as a lessee, entered into an agreement with an independent lessor for operating leases of three 737-800 aircraft for a term of 138 months, with total future lease payments totalling approximately Rmb986 million, scheduled for deliveries in 2006.

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In November 2005, CSA, as a lessee, entered into an agreement with an independent lessor for operating leases of five A320-200 aircraft for a term of 140 months with total future lease payments totalling approximately Rmb1,694 million, scheduled for deliveries in 2006; and

In August 2005, CSA entered into two separate purchase agreements with Boeing and Airbus SNC respectively for the purchase of ten B787 aircraft, which are scheduled for deliveries in 2008 to 2010, and ten A330 aircraft, which are scheduled for deliveries in 2007 and 2008.

Aircraft Financing Arrangements

Overview

A significant portion of the Group s aircraft is acquired under long-term capital or operating leases or long-term mortgage loans with remaining terms to maturity ranging from one to fifteen years. As of December 31, 2005, 65 of the Group s 261 aircraft were operated under capital leases, 86 were operated under operating leases, 51 were financed by long-term mortgage loans, while the remaining were acquired either with cash proceeds or acquired by exercising the purchase options upon expiry of the respective capital leases. The Group s planned acquisition of aircraft in the foreseeable future will generally be made pursuant to operating leases or capital leases. The Group s determination as to its acquisition strategy depends on the Group s evaluation at the time of its capacity requirements, anticipated deliveries of aircraft, the Group s capital structure and cash flow, prevailing interest rates and other general market conditions.

The following table sets forth, as of December 31, 2005, the number of aircraft operated by the Group pursuant to capital and operating leases and the remaining terms, expressed in years, of such leases.

Model	Capital Lease	Operating Lease	Average Remaining Lease Term
Boeing 777-200 and 777-21B	5	4	4.48
Boeing 757-200		15	3.10
Boeing 737-700		10	5.60
Boeing 737-800		3	8.17
Boeing 737-500		15	0.99
Boeing 737-300	4	10	1.32
Airbus 300-600	6		1.20
Airbus 319-100	6	15	9.05
Airbus 320-200	24	6	4.35
Airbus 321-100	6		8.02
Airbus 330-200	4		11.28
McDonnell Douglas 82		8	2.17
McDonnell Douglas 90	10		1.69
	65	86	

Capital Leases

As of December 31, 2005, the Group s aggregate future minimum lease payments (including future finance charges) required under its capital leases were RMB18,615 million (US$2,307 million). As of year end 2005, a majority of the Group s capital leases had original terms ranging from ten to fifteen years from the date of delivery of the relevant aircraft, and the remaining terms of these leases ranged from one to twelve years. The Group s capital leases typically cover a significant portion of the relevant aircraft s useful life and transfer the benefits and risks of ownership to the Group. Under its capital leases, the Group generally has an option to purchase the aircraft at or near the end of the lease term. As a customary in the case of capital leases, the Group s obligations are secured by the related aircraft, as well as other collateral.

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Operating Leases

As of December 31, 2005, the Group s aggregate future minimum lease payments required under its operating leases were RMB24,594 million (US$3,048 million). As of year end 2005, the Group s operating leases had original terms generally ranging from eight to ten years from the date of delivery of the relevant aircraft, and the remaining terms of these leases generally ranged from one to ten years. Pursuant to the terms of the operating leases, the Group is obligated to make rental payments based on the lease term, with no termination payment obligations or purchase option, and the lessor bears the economic benefits and risks of ownership. Under its operating leases, the Group has no option to purchase the aircraft and is required to return the aircraft in the agreed condition at the end of the lease term. Although title to the aircraft remains with the lessor, the Group is responsible during the lease term for the maintenance, servicing, insurance, repair and overhaul of the aircraft.

Pursuant to capital or operating leases, the Group is obligated 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 pursuant to such leases. In accordance with relevant PRC tax regulations, a PRC lessee is liable to pay PRC withholding tax in respect of any lease payments regularly made to an overseas lessor. Depending on the circumstances, this tax is generally imposed at a fixed rate ranging from 10% to 20% of the lease payments, or in certain cases, the interest components of such payments. Pursuant to an approval document from the State Taxation Bureau, lease arrangements executed prior to September 1, 1999 are exempt from PRC withholding tax. The PRC withholding tax payable in respect of the operating leases executed after September 1, 1999 of RMB8 million, RMB23 million and RMB55 million during 2003, 2004 and 2005 respectively, have been included as part of the operating lease charges.

Aircraft Flight Equipment

The jet engines used in the Group s aircraft fleet are manufactured by General Electric Corporation, Rolls-Royce plc, United Technologies International, Inc., CFM International, Inc. and International Aviation Engines Corporation. As of year end 2005, the Group had 67 spare jet engines for its fleet. The Group determines its requirements for jet engines based on all relevant considerations, including manufacturers recommendations, the performance history of the jet engines and the planned utilization of its aircraft. Rotables and certain of the expendables for the Group s aircraft are generally purchased by Southern Airlines (Group) Import & Export Trading Corporation (SAIETC), a subsidiary of CSAHC acting as agent for the Group, in consideration of an agency fee. The Group arranges the ordering of aircraft, jet engines and other flight equipment for the Airline Subsidiaries and keeps an inventory of rotables and expendables for the Airline Subsidiaries.

Aircraft Maintenance

A major part of the maintenance for the Group s fleet other than overhauls of jet engines is performed by GAMECO, a jointly controlled entity established by the Company, Hutchison Whampoa (Hutchison) and South China International Aircraft Engineering Company Limited, consistent with the Group s strategy to achieve fully integrated airline operations and to assure continued access to a stable source of high quality maintenance services. The remaining part of the maintenance for the Group s fleet other than overhauls of jet engines is performed by service providers in China and overseas. GAMECO performs all types of maintenance services, ranging from maintenance inspections performed on aircraft before, after and between flights (line maintenance services) to major overhaul performed at specified intervals. GAMECO was the first of three aircraft maintenance facilities in China having been certified as a repair station by both the CAAC and the FAA. In March 1998, GAMECO received an approval certificate from the United Kingdom Civil Aviation Authority for the repair and maintenance of aircraft and aircraft engines.

The Group believes that GAMECO performs major maintenance checks on the Group s aircraft within time periods generally consistent with those of large international airline maintenance centers. GAMECO s repair and maintenance capabilities include overhaul of more than 90% of the Group s aircraft. Although rotables for the Group s aircraft are generally imported through SAIETC, a portion of expendables and other maintenance materials are directly imported by GAMECO. GAMECO also provides line maintenance services to 7 other Chinese airlines and 19 international airlines. GAMECO provides heavy maintenance services to 5 other Chinese airlines and 11 international airlines.

The Company and GAMECO had entered into an Aircraft Maintenance and Engineering Agreement for the provision of aircraft repair and maintenance services. On May 17, 1996, the Company and GAMECO entered into an agreement regarding the fee arrangement for the provision of such repair and maintenance services (the Fee Agreement). Pursuant to the Fee Agreement and subsequent agreements, GAMECO charged the Company for expendables at cost plus 16%, and labour costs at US$30 per hour during 2005. For the year ended December 31, 2005, the amount incurred by the Group for such repair and maintenance services was RMB535 million.

Overhauls of jet engines are performed by overseas qualified service providers in Germany, Malaysia, Canada and England. Starting from 2003, MTU Maintenance Zhuhai Co., Ltd., (MTU Zhuhai) a jointly controlled entity of the Company and MTU Aero Engines Gmbh., also performed overhauls of certain jet engines for the Group. For the year ended December 31, 2005, repair fees amounting to RMB583 million were paid to MTU Zhuhai.

Safety

The Group endeavors to maintain strict compliance with all laws and regulations applicable to flight safety. In addition, the Group has adopted measures to eliminate or minimize factors that may impair flight safety, including specialized training programs and safety manuals. The Air Safety Management Department of the Company implements safety-related training programs on an ongoing basis in all of the Group s operations to raise the safety awareness of all employees. As a result, overall flight safety has gradually improved. There were no serious incidents involving casualty or flight damage throughout the three years ended December 31, 2005. For minor incidents which include various events and conditions prescribed by the CAAC which do not involve serious personal injury or material damage to flight equipment, the Group has kept the number consistently below the standard prescribed by the CAAC. For example, the Company s flight incident ratio was 0.13, 0.13 and 0.13 in 2003, 2004 and 2005, respectively. In comparison, CAAC s published maximum acceptable flight incident ratio was 1.3 in 2003 and 0.9 in 2004 and 0.29 in 2005. This ratio is defined as the occurrence of one incident for every 10,000 hours of flight time.

Jet Fuel

Jet fuel costs typically represent a major component of an airline s operating expenses. The Group s jet fuel costs for 2005 accounted for 30.1% of the Group s operating expenses. Like all Chinese airlines, the Group is generally required by the Chinese Government to purchase its jet fuel requirements from regional branches of CAOSC and Bluesky Oil Supplies Company, except at the Shenzhen, Zhuhai and Sanya airports which are supplied by Sino-foreign joint ventures in which CAOSC is a joint venture partner. CAOSC is a State-owned organization controlled and supervised by the CAAC that controls the importation and distribution of jet fuel throughout China.

Jet fuel obtained from CAOSC s regional branches is purchased at uniform prices throughout China that are determined and adjusted by CAOSC from time to time with the approval of the CAAC and the pricing department of the National Development and Reform Commission (NDRC) based on market conditions and other factors. As a result, the costs of transportation and storage of jet fuel in all regions of China are spread among all domestic airlines. Jet fuel costs in China are influenced by costs at State-owned oil refineries and limitations in the transportation infrastructure, as well as by insufficient storage facilities for jet fuel in certain regions of China.

Prior to 1994, domestic jet fuel prices were generally below international jet fuel prices. The Chinese Government had gradually increased domestic jet fuel prices in order to reflect more accurately the costs of supplying jet fuel in China. As a result, domestic jet fuel prices have become higher than those in the international market since the beginning of 1994. With the WTO entry, the jet fuel price in China will probably be trimmed by the market force to be in line with the international market.

CAOSC s maximum fuel price in 2005 was RMB5,220 per ton. The average price paid by the Group in 2005 was RMB4,846 per ton, which represents a 28.47% increase from that of 2004.

According to the Notice of the National Development and Reform Commission (NDRC) and the Civil Aviation Administration of China (CAAC) on Issues Relating to Introduction of the Fuel Surcharge for Domestic Routes, domestic airlines imposed fuel surcharges for all the domestic routes (excluding those from the mainland PRC to Hong Kong and Macau) with effect from August 1, 2005 (based on flight time). On February 16, 2006, the NDRC and CAAC released a supplementary document on Issues Relating to the Introduction of Fuel Surcharge for Domestic Routes, stating that due to the rising jet fuel price, the period of imposition of fuel surcharge by airlines was extended. On 28 March 2006, the NDRC and CAAC released another supplementary document on Issues Relating to the Introduction of Fuel Surcharge for Domestic Routes, thereby adjusting the amount of fuel surcharges from RMB20 to RMB30 per passenger for distance flown being less than 800 kilometres, and from RMB40 to RMB60 for distance exceeding 800 kilometres, during the period temporarily from April 10, 2006 to October 10, 2006. The introduction of fuel surcharge and the extension of the duration of the same will help relieve, to a certain extent, the burden of high jet fuel cost on the Group.

In addition to purchases of jet fuel from CAOSC, the Group is also permitted by the Chinese Government to purchase a portion of its jet fuel requirements for its international flights from foreign fuel suppliers located outside China at prevailing international market prices. Jet fuel purchased from such sources outside China accounted for approximately 20% of the Group s total jet fuel consumption in 2005.

Flight Operations

Flight operations for the Group s flights originating in Guangzhou are managed by the Company s flight operations and marketing divisions, which are responsible for formulating flight plans and schedules consistent with route and flight approvals received from the CAAC. The Company s flight operations center in Guangzhou is responsible for the on-site administration of flights, including the dispatch and coordination of flights, deployment of aircraft, ground services and crew staffing. In addition, each of the Airline Subsidiaries maintains flight operations centers at all servicing airports for on-site administration of their flights. The Company s general dispatch offices are responsible for monitoring conditions on the Group s route network, administering the Group s flight plans, collecting and monitoring navigation data and analyzing and monitoring airport conditions.

To enhance its management of flight operations, the Group s computerized flight operations control system (SOC) began operation in May 1999. The system utilizes advanced computer and telecommunications technology to manage the Group s flights on a centralized, realtime basis. The Group believes that the system will assist it to (i) compile flight schedules more efficiently; (ii) increase the utilization of aircraft; (iii) allow real-time tracking of all of the Group s flights; and (iv) improve coordination of the Group s aircraft maintenance and ground servicing functions.

Training of Pilots and Flight Attendants

The Group believes that its pilot training program which was established in cooperation with the CAAC affiliated Beijing Aeronautics and Aviation University (the BAAU) has significantly improved the quality of the training received by the Group s pilots and has helped maintain the quality of the Group s staff of pilots at a level consistent with the expansion of operations called for by the Group s business strategy.

In the Group s pilot training program, trainees have two years of theoretical training at the BAAU. After successful completion of academic and physical examinations, students receive flight training for a period of approximately 20 months at China Southern West Australian Flying College Pty Ltd. (the Australian Pilot College), a company that is 65% owned by the Company and 35% owned by CSAHC. Each student at the Australian Pilot College is required to fly at least 230 hours before being awarded a flight certificate. Graduates of the BAAU and the Australian Pilot College are hired by the Group as trainee pilots after passing a CAAC-administered examination to obtain a pilot license. The total training period for the Group s trainee pilots is approximately five years. About 110 trainee pilots graduated from the Australian Pilot College each year.

Prior to January 2003, as part of the pilot training program, the Group also operated a flight simulator training center in Zhuhai, Guangdong Province (the Zhuhai Training Center), which was equipped with simulators for all models of aircraft currently operated by the Group. Trainee pilots received their initial training in the operation of a specific aircraft at the Zhuhai Training Center, which also provided training to pilots from other Chinese airlines. Such flight simulation training has been shifted to Zhuhai Xiang Yi Aviation Technology Company Limited (Zhuhai Xiang Yi), a jointly controlled entity between the Company and CAE International Holdings Limited, since January 2003. Zhuhai Xiang Yi currently leases the flight simulation facilities of Zhuhai Training Center from the Group and provides flight simulation training services to the Group.

The Group s pilots are required to be licensed by the CAAC, which requires an annual recertification examination. The Group s pilots attend courses in simulator training twice annually and in simulator emergency procedures annually. The Group also conducts regular advanced training courses for captains and captain candidates. Pilots advance in rank based on number of hours flown, types of aircraft flown and their performance history.

The Group conducts theoretical and practical training programs for its flight attendants at its Flight Attendants Training Center in Guangzhou (the Guangzhou Training Center). The Guangzhou Training Center is equipped with computerized training equipment, as well as simulator cabins for all models of aircraft currently operated by the Group. At the Guangzhou Training Center, flight attendants of the Group receive comprehensive training in areas such as in-flight service, emergency evacuation and water rescue.

Ground Services

The Group makes arrangements with airport authorities, other airlines or ground services companies for substantially all ground facilities, including jet-ways, waiting areas, ticket counters and support services buildings, at each airport that it serves. The Group pays landing, parking and other fees to such airports, including Baiyun International Airport in Guangzhou. At domestic airports, such fees are generally determined by the CAAC.

At new Baiyun International Airport in Guangzhou, the Group operates its own passenger check-in, cargo, mail and baggage handling, aircraft maintenance and cleaning services. The Group also provides such services to other airlines that operate in new Baiyun International Airport.

Ground services at the airports in Shenzhen, Changsha,Wuhan, Zhengzhou, Haikou, Zhuhai, Xiamen, Fuzhou, Guilin, Shantou, Guiyang and Beihai are primarily operated directly by the Group. Ground services at other airports in China are provided to the Group by local airport authorities or local airlines pursuant to various service agreements. Ground services and other services at airports outside China are provided to the Group by foreign services providers pursuant to various service agreements with such parties. All such agreements of the Group are short term and otherwise on terms that are customary in the industry.

Air Catering

The Company owns a 75% equity interest in Guangzhou Nanland Air Catering Company Limited (Nanland). Nanland provides in-flight meals, snacks, drinks and related services for all of the Group s flights originating in Guangzhou and substantially all other flights departing from new Baiyun International Airport. The Group contracts with various air catering suppliers with respect to in-flight catering services for flights originating from other airports, generally on an annual basis and otherwise on terms that are customary in the industry.

Cargo and Mail

The Group also provides air cargo and mail services. A significant portion of these services is combined with passenger flights services. Currently, the Group also has two Boeing 747-400 freighters servicing three international cargo routes, Shenzhen to Chicago and Shenzhen to Shanghai to Belgium and Shanghai to Amsterdam.

Currently, the Group conducts its cargo business primarily through its cargo division in Shenzhen. To further tap into the growing cargo market, the Group has commenced the construction of a cargo centre in the Guangzhou new airport in 2004 and the construction was completed in 2005.

Sales, Reservations and Marketing

Passenger Ticket Sales and Reservations

The Group s ticket sales and reservations are conducted by or through independent sales agents and the Group s own network of exclusive sales offices as well as the CAAC s sales offices and CSAHC s affiliates. The Group has sales offices in Guangzhou and its other route bases. In addition, the Group maintains regional sales offices in other cities in China, including Beijing and Shanghai. The Group maintains international sales offices in Bangkok, Manila, Hanoi, Ho Chi Minh City, Singapore, Kuala Lumpur, Penang, Jakarta and Phnom Penh in Southeast Asia, as well as in Sendai, Toyame, Hiroshima, Nagoya, Niigata, Osaka, Fukuoka, Tokyo, Seoul, Daejeon, Daegu, Busan Amsterdam, Los Angeles, Sydney, Paris, Melbourne and Sharjah.

In Hong Kong, ticket sales and reservations services are provided to the Group by China National Aviation Corporation and Nanlung Travel Agency Limited (a subsidiary of CSAHC) for a commission of 3% 9% of the ticket price. The Group also has agency agreements with airlines in the Asia-Pacific region, Europe, the United States and Africa for the processing of ticket sales and reservations on a reciprocal basis. In 2005, approximately 30% of all ticket sales for the Group s scheduled flights were made by the Group s and CAAC s network of sales offices and CSAHC s affiliates. The Group also sells tickets and accepts reservations through an extensive network of non-exclusive independent sales agents, substantially all of whom operate in cities throughout China, with the remainder operating principally in Hong Kong and other Southeast Asian destinations served by the Group. Under the agency agreements with these sales agents, the Group pays commissions based on the value of tickets sold. The Group pays independent sales agents in China a commission of 3% of the ticket price, and pays independent sales agents outside China a commission ranging from 5% 9% of the ticket price. Sales agents are typically permitted to withhold their commission from the proceeds of ticket sales that are remitted to the Group. In 2005, independent sales agents accounted for approximately 70% of the Group s ticket sales for its scheduled flights.

Substantially all of the Group s sales offices and agents in China are linked electronically to the CAAC s computerized ticketing and reservations system, which is in turn linked to all domestic airlines for flights throughout China. The Group has also entered into membership agreements with several international reservation systems, including ABACUS in Southeast Asia, SABRE and GALILEO in the United States, AMADEUS in Europe and INFINI in Japan. These systems facilitate reservations and sales of tickets for the Group s international flights.

Cargo

The Group s cargo and mail services are promoted through its own cargo divisions and independent cargo agents both within and outside China that track available space among all airlines. In particular, the Group employs a number of cargo agents in the Pearl River delta region. The Group generally pays such agents a commission of 4% 5% of the relevant cargo freight rate for domestic and international services, respectively.

Promotional and Marketing Activities

The Group engages in regular promotional and marketing activities in an effort to increase its market share. The Group s promotional and marketing activities for domestic routes emphasize safety, passenger comfort and the frequency of the Group s flights. The Group s promotional and marketing activities for international and Hong Kong regional passengers emphasize the Group s quality of service, extensive route network in China and greater frequency of flights relative to other Chinese airlines. In addition, the Group also promotes and markets its Hong Kong regional and international routes on the basis of price.

The Group has been seeking to increase its name recognition by offering new services to passengers. For example, the Group was the first Chinese airline to provide off-airport check-in services. The Group also offers transfer and baggage through-handling services to passengers connecting to other airlines, including passengers connecting in Hong Kong for flights to Taiwan.

To enhance relationships with its passengers, the Group has launched two frequent flyer programs, namely the China Southern Airlines Sky Pearl Club , and the Egret Mileage Plus . By the end of 2005, the Group had approximately 4,055,600 members under these programs.

Regulation

The Chinese commercial aviation industry is subject to a high degree of regulation and oversight by the CAAC. Regulations and policies issued or implemented by the CAAC encompass substantially all aspects of airline operations, including the approval of domestic, Hong Kong and Macau and international route allocation, published airfares, aircraft acquisition, jet fuel prices and standards for aircraft maintenance, airport operations and air traffic control. The Civil Aviation Law, which became effective in March 1996, provides a framework for regulation of many of these aspects of commercial aviation activities. Although China s airlines operate under the supervision and regulation of the CAAC, they are accorded an increasingly significant degree of operational autonomy, including with respect to the application for domestic, Hong Kong and Macau and international routes, the allocation of aircraft among routes, the purchase of flight equipment, the pricing of air fares within a certain range, the training and supervision of personnel and their day-to-day operations.

As an airline providing services on international routes, the Group is also subject to a variety of bilateral civil air transport agreements that provide for the exchange of air traffic rights between China and various other countries. In addition, China is a contracting state, as well as a permanent member, of the International Civil Aviation Organization (the ICAO), an agency of the United Nations established in 1947 to assist in the planning and development of international air transport, and is a party to many other international aviation conventions. The ICAO establishes technical standards for the international aviation industry. The Group believes that it, in all material respects, complies with all such technical standards.

Route Rights

Domestic Routes. The right of any Chinese airline to carry passengers or cargo on any domestic route must be obtained from the CAAC. Non-Chinese airlines are not permitted to provide domestic air service between destinations in China. The CAAC s policy is to assign a domestic route to the Chinese airline that is best suited to serve the route based, in part, on the location of the airline s main or regional base at the point of origin. Under current regulations, airlines are generally expected to operate mainly from their route bases, and flights within a particular region are expected to be served by airlines based in that region. The Group believes that these regulatory parameters benefit airlines, such as the Group, that have a large number of regional route bases. The CAAC also considers other factors that may make a particular airline suitable to operate a domestic route, including the applicant s general operating authority, compliance with pricing regulations and regulations applicable to safety and service quality, market demand, the ability of the applicant in terms of its existing routes, and airport facilities and related support services.

The CAAC considers market conditions for a domestic route in determining whether the route should be allocated to one or more airlines. The CAAC requires the passenger load factor on a particular route to reach 75% before additional flights may be added on that route. Airlines serving the route are given priority for such additional flights, and only if such airlines cannot operate more flights will the CAAC permit another airline to commence service.

Hong Kong and Macau Routes. Hong Kong and Macau routes and landing rights are derived from agreements between the Chinese Government and the government of the Hong Kong SAR, and between the Chinese Government and the government of Macau SAR. Such rights are allocated by the CAAC among the four Chinese airlines permitted to fly to Hong Kong or Macau. The Group understands that the criteria for determining whether a Hong Kong and Macau route will be allocated to a particular airline, include market demand, the ability of the airline to service the route and the appropriateness of the airline s aircraft for such route.

A number of Hong Kong routes are operated by Chinese airlines on a charter flight basis. Permission to operate these flights is in theory subject to monthly review by the CAAC and the Hong Kong Civil Aviation Department. The CAAC has informally indicated that it primarily considers market demand and airline capability in granting permission for such flights.

International Routes. International route rights, as well as the corresponding landing rights, are derived from air services agreements negotiated between the Chinese Government, through the CAAC, and the government of the relevant foreign country. Each government grants to the other the right to designate one or more domestic airlines to operate scheduled service between certain destinations within each of such countries. Upon entering into an air services agreement, the CAAC determines the airline to be awarded such routes based on various criteria, including the availability of appropriate aircraft, flight and management personnel, safety record, the overall size of the airline, financial condition and sufficiency of assets to bear civil liabilities in international air services. These route rights may be terminated by the CAAC under special circumstances.

The criteria for determining whether an international route will be allocated to a second airline generally include (i) the terms of the relevant bilateral civil aviation agreement; (ii) consistency with overall national plans and the national interest and the enhancement of reasonable competition; and (iii) whether the international airports to be used are sufficient for the aircraft flown and employ security measures consistent with international standards.

In addition, if the relevant bilateral civil aviation agreement permits more than one Chinese airline to operate a particular international route, the CAAC will only permit a second airline to operate on such route if the number of passengers carried annually exceeds 100,000 and if there is a minimum average load factor of 68% for routes with at least five weekly flights by Chinese airlines, or 80% for routes with four or fewer weekly flights by Chinese airlines.

Air Fare Pricing Policy

Pursuant to Pricing Reform of Domestic Civil Aviation as approved by the State Council of the PRC effective on April 20, 2004, prices on domestic routes now fluctuate freely within a predetermined range. Instead of direct supervision by setting prices of air tickets through local price bureau, the government now provides guidance on domestic flights and domestic civil aviation is controlled by the government indirectly. Market-oriented pricing policy was introduced and pricing system has been adjusted as a result of the above pricing reform.

Published air fares of Chinese airlines for the Hong Kong and Macau routes are determined by the CAAC and the relevant civil aviation authorities in Hong Kong or Macau, subject to consultation between the relevant Chinese airlines and Hong Kong or Macau airlines. Airlines may offer discounts on flights on their Hong Kong regional routes.

Published air fares of Chinese airlines for international routes are determined through consultation between the relevant Chinese airlines and foreign airlines in accordance with the civil aviation agreements between the Chinese Government and the relevant foreign government, taking into account the international air fare standards established through the International Air Transport Association. All air fares for international routes must be approved by the CAAC. Discounting of published international air fares is permitted.

Acquisition of Aircraft and Flight Equipment

The CAAC requires all Chinese airlines to acquire their aircraft through China Aviation Supplies Import and Export Corporation (CASC), an entity controlled by the CAAC. If a Chinese airline plans to acquire an aircraft, the airline must first seek approval from the CAAC and NDRC. The airline must, as a condition of approval, provide specific acquisition plans, which are subject to modification by the CAAC and NDRC. If the CAAC and NDRC approve an aircraft acquisition, the airline negotiates the terms of the acquisition with the manufacturer together with CASC because CASC possesses the license required to import or export aircraft, and CASC receives a commission in respect thereof. Most Chinese airlines are also required to acquire their aircraft engines, spare parts and other flight equipment through CASC. The Company and a few other Chinese airlines are permitted to import jet engines and other flight equipment for their own use without the participation of CASC. In the case of the Company, SAIETC acts as its importer agent and is paid an agency fee for its services.

Jet Fuel Supply and Pricing

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CAOSC and Bluesky Oil Supplies Company, companies controlled and supervised by the CAAC, are the only jet fuel supply companies in China, with the exception of the joint venture jet fuel supply companies that supply the Shenzhen, Zhuhai and Sanya airports, in each of which CAOSC is a partner. Airlines are generally not permitted to buy jet fuel from other suppliers in their domestic operations, since the direct import of jet fuel for domestic purposes is prohibited. As a result, all Chinese airlines purchase their domestic jet fuel supply requirements (other than in respect of their Shenzhen, Zhuhai or Sanya operations) from the seven regional branches of CAOSC. Jet fuel obtained from such regional branches is purchased at uniform prices throughout China that are determined and adjusted by CAOSC from time to time with the approval of the CAAC and the pricing department of the NDRC based on market conditions and other factors.

Safety

The CAAC has made the improvement of air traffic safety in China a high priority and is responsible for the establishment of operational safety, maintenance and training standards for all Chinese airlines. The Chinese airlines are required to provide monthly flight safety reports to the CAAC, including reports of flight or other incidents or accidents and other safety related problems involving such airline s aircraft occurring during the relevant reporting period. The CAAC periodically conducts safety inspections on individual airlines.

The CAAC oversees the standards of all Chinese airline pilots through its operation of the CAAC Aviation College. The CAAC Aviation College is a monitoring unit located in Tianjin which implements a uniform pilot certification process applicable to all Chinese airline pilots and is responsible for the issuance, renewal, suspension and cancellation of pilot licenses. Every pilot is required to pass CAAC-administered examinations before obtaining a pilot license and is subject to an annual recertification examination.

All aircraft operated by Chinese airlines, other than a limited number of leased aircraft registered in foreign countries, are required to be registered with the CAAC. All aircraft operated by Chinese airlines must have a valid certificate of airworthiness, which is issued annually by the CAAC. In addition, maintenance permits are issued to a Chinese airline only after its maintenance capabilities have been examined and assessed by the CAAC. Such maintenance permits are renewed annually. All aircraft operated by Chinese airlines may be maintained and repaired only by CAAC-certified maintenance facilities, whether located within or outside China. Aircraft maintenance personnel must be certified by the CAAC before assuming aircraft maintenance posts.

Security

The CAAC establishes and supervises the implementation of security standards and regulations for the Chinese commercial aviation industry. Such standards and regulations are based on Chinese laws, as well as standards developed by international commercial aviation organizations. Each airline and airport in China is required to submit to the CAAC an aviation security handbook describing specific security procedures established by such airline or airport for the day-to-day operations of commercial aviation and procedures for staff training on security. Such security procedures must be based on relevant CAAC regulations and international commercial aviation treaties. Chinese airports and airlines that operate international routes must also adopt security measures in accordance with the requirements of the relevant international agreements.

Noise and Environmental Regulation

All airlines in China must comply with the noise and environmental regulations of the PRC State Environmental Protection Agency. Applicable regulations of the CAAC permit Chinese airports to refuse take-off and landing rights to any aircraft that does not comply with noise regulations.

Chinese Airport Policy

The CAAC supervises and regulates all civilian airports in China. The local government of the PRC manages the administration of most civilian airports in China, including the new Baiyun International Airport as of 2005, with limited exceptions. Airports in China are also subject to regulation and ongoing review by the CAAC, which determines take-off and landing charges, as well as charges for the use of airports and airport services.

Competition

The CAAC s extensive regulation of the Chinese commercial aviation industry has had the effect of managing competition among Chinese airlines. Nevertheless, competition has become increasingly intense in recent years due to a number of factors, including relaxation of certain regulations by the CAAC, an increase in the number of Chinese airlines and an increase in the capacity, routes and flights of Chinese airlines.

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In the Chinese aviation industry, the three dominant airlines are the Group, Air China and China Eastern Airlines (China Eastern). In 2005, these three airlines together controlled approximately 74.84% of the commercial aviation market in China as measured by passengers carried.

Most major Chinese airlines have in recent years significantly expanded their fleets, while at the same time, passenger traffic has not increased proportionately. This has resulted in a reduction in the passenger load factors for most Chinese airlines. As a result, Chinese airlines are required to be more competitive with respect to, for example, quality of service, including ticketing and reservations, in-flight services, flight scheduling and timeliness.

The Group expects that competition in China s commercial aviation industry will continue to be intense. The Group will also face increasing competition from alternative means of transport, such as highway and rail, as China s transportation infrastructure improves.

Relative to other Chinese airlines, however, the Group believes that it possesses certain competitive advantages. The Group has the most extensive route network and the largest number of regional route bases among Chinese airlines, which the Group believes places it in a favorable position in the route allocation process. The Group also has the largest aircraft fleet of any Chinese airline, which, together with the Group s planned aircraft acquisitions, will permit the Group to expand its operations and to improve the deployment of the aircraft in its fleet. The Group also believes that its dominant presence in the populous and economically developed southern and central regions of China provides it with a competitive advantage in attracting new customers and that its fully integrated flight training, aircraft and engine maintenance, and air catering operations enable it to achieve and maintain high quality service to its customers.

The following table sets forth the Group s market share of passengers carried, cargo and mail carried and total traffic of Chinese airlines for the years indicated.

	Passenger carried		**Cargo and Mail Carried (tons)**		**Total traffic (ton kilometers)**	
Year	**Industry Total (in million)**	**Group s Share (% of total)**	**Industry Total (in thousand)**	**Group s Share (% of total)**	**Industry Total (in billion)**	**Group s Share (% of total)**
1999	60.9	24.8	1,704	22.9	10.6	18.9
2000	67.2	24.9	1,967	22.5	12.3	20.0
2001	75.2	25.4	1,709	23.3	14.1	21.5
2002	85.9	25.0	2,021	23.3	16.5	21.9
2003	87.6	23.4	2,190	21.2	17.1	20.8
2004	121.2	23.3	2,770	19.7	23.1	20.2
2005	138.3	31.8	3,067	25.3	26.1	27.9

Domestic Routes

The Group competes against its domestic competitors primarily on the basis of flight schedule, route network, quality of service, safety, type and age of aircraft and, to a lesser extent and until recently, price. The Group competes against 10 other Chinese airlines in its various domestic route markets. Of these competitors, the largest are two airlines owned or controlled by the Chinese Government, and the remaining eight airlines are operated by or under the control of various Chinese provincial or municipal governments.

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The following table sets forth the Group s market share of the passengers carried, cargo and mail carried on departing flights and total departing flights at the ten busiest airports in China, based on passenger volume, in 2005.

Airport	Passenger carried (% of total)	Cargo and Mail Carried (% of total)	Departing flight (% of total)
Beijing	19.14%	19.06%	17.95%
Shanghai Pudong	9.86%	5.13%	10.38%
Guangzhou	54.71%	45.10%	53.75%
Shanghai Hongqiao	18.18%	18.41%	16.95%
Shenzhen	33.08%	31.59%	29.98%
Chengdu	13.99%	17.07%	10.72%
Kunming	21.71%	18.27%	18.24%
Hangzhou	38.31%	32.91%	35.00%
Xian	14.75%	19.69%	10.18%
Haikou	30.26%	33.19%	23.73%

The following table sets forth the Group s market share of the passengers carried, cargo and mail carried on departing flights and total departing flights at 8 busiest airports in southern and central China (excluding Guangzhou, Shenzhen and Haikou, which are included in the table above), based on passenger volume, in 2005.

Airport	Passenger carried (% of total)	Cargo and Mail Carried (% of total)	Departing flight (% of total)
Changsha	51.60%	71.54%	47.39%
Wuhan Tianhe	39.60%	43.56%	33.79%
Guilin	38.90%	38.26%	38.69%
Sanya	43.45%	29.70%	40.33%
Zhengzhou	71.79%	61.78%	59.17%
Nanning	43.60%	40.67%	35.27%
Zhang Jia Jie	40.45%	80.56%	38.33%
Shantou	81.64%	80.67%	69.55%

Hong Kong and Macau Routes

The Group dominates the routes operated by Chinese airlines between Hong Kong and Macau and China. In 2005, the Group operated an average of more than 17,807 charter and other scheduled flights per week between China and Hong Kong or Macau, accounting for approximately 34.4% of the total number of passengers carried by all Chinese airlines on the Hong Kong and Macau routes. The Group believes that the routes on which it operates charter flights are among its highest yielding routes, primarily because the Group faces limited competition on such routes and is consequently less subject to downward pricing pressures. Dragon Air, which is a Hong Kong-based airline, competes with the Group on many of the Group s Hong Kong and Macau routes.

Air Macau Group Ltd. (Air Macau), a Macau-based airline, started to operate routes in 1996 between Macau and China, including destinations such as Beijing, Shanghai, Xiamen and Wuhan. Air Macau also operates routes between Macau and Taiwan, including flights which allow passengers to travel between Taiwan and China through Macau. The air fares on some of Air Macau s routes are significantly less than air fares on comparable routes of the Group. Air Macau s routes provide an alternative to and compete with the Group s Hong Kong and Macau routes for passengers travelling between Taiwan and China.

International Routes

The Group competes with Air China, China Eastern and many well-established foreign airlines on its international routes. Most of these international competitors have significantly longer operating histories, substantially greater financial and technological resources and greater name recognition than the Group. In addition, the public s perception of the safety and service records of Chinese airlines may adversely affect the Group s ability to compete against its Hong Kong and Macau and international competitors. Many of the Group s international competitors have larger sales networks and participate in reservation systems that are more comprehensive and convenient than those of the Group, or engage in promotional activities that may enhance their ability to attract international passengers.

Air China has the most extensive international route network among Chinese airlines. Beijing, the hub of Air China s operations, has been the destination for most international flights to China. The Group competes against, among other airlines, Thai Airways International, Singapore Airlines, Malaysian Airlines System, Air China and China Eastern on flights to Southeast Asian destinations. In the case of its European routes, the Group s competitors include Air France KLM. The Group faces competition on its international route from Air China and China Eastern, each of which operates several routes between destinations in China and the United States, as well as international airlines that fly to Los Angeles from Hong Kong. The Group competes in the international market primarily on the basis of safety, price, timeliness and convenience of scheduling.

Airline Subsidiaries

The Airline Subsidiaries are joint ventures established by the Company and local companies in the provinces or special economic zones where the Airline Subsidiaries are based and are engaged in providing airline and related services. Except for Guangxi Airlines, of which the Company has 95% equity interest, the Company owns 60% equity interest in each of the remaining Airline Subsidiaries.

As of December 31, 2005, Xiamen Airlines operated under its own MF code a fleet of 34 aircraft on 96 domestic routes, 9 international route and 7 Hong Kong and Macau routes. In 2005, Xiamen Airlines carried a total of about 6.92 million passengers, or approximately 15.7% of the passengers carried by the Group in that year, and had RMB4,852 million in operating revenue.

As of December 31, 2005, Shantou Airlines operated under the Group s CZ code 6 aircraft on 12 domestic routes, 1 international route and 1 Hong Kong and Macau route. In 2005, Shantou Airlines carried a total of about 1.17 million passengers, or 2.7% of the passengers carried by the Group in that year. Total operating revenue of Shantou Airlines for the year ended December 31, 2005 was RMB844 million.

As of December 31, 2005, Guangxi Airlines operated under the CZ code 5 aircraft on 15 domestic routes, 4 international routes and 2 Hong Kong and Macau routes. In 2005, Guangxi Airlines carried a total of about 1.03 million passengers, or 2.3% of the total number of passengers carried by the Group in that year. Total operating revenue of Guangxi Airlines for the year ended December 31, 2005 was RMB722 million.

As of December 31, 2005, Zhuhai Airlines operated under the CZ code 5 aircraft on 10 domestic routes. In 2005, Zhuhai Airlines carried a total of about 834,000 passengers, or approximately 1.9% of the total number of passengers carried by the Group in that year. Total operating revenue of Zhuhai Airlines for the year ended December 31, 2005 was RMB719 million.

As of December 31, 2005, Guizhou Airlines operated under the CZ code 6 aircraft on 14 domestic routes. In 2005, Guizhou Airlines carried a total of about 1.34 million passengers, or approximately 3.0% of the total number of passengers carried by the Group in 2005. Total operating revenue of Guizhou Airlines was approximately RMB882 million for the year ended December 31, 2005.

Insurance

The CAAC maintains fleet and legal liability insurance on behalf of the Group and all other Chinese airlines with the People s Insurance Company of China (PICC) under the PICC master policy. The Group maintains aviation hull all risks, spares and airline liability insurance, aircraft hull all risks and spare engines deductible insurance, aviation hull war and allied perils policy of the type and in the amount customary in the Chinese aviation industry.

Under Chinese law, civil liability of Chinese airlines for injuries suffered by passengers on domestic flights is limited to RMB70,000 (approximately US$8,455) per passenger. Under the Convention for the Unification of Certain Rules Relating to International Transportation by Air of 1929 (as amended by the protocol of 1955, the Warsaw Convention), unless a separate agreement has been entered into between China and a specific country, civil liability for injuries suffered by passengers on international flights is limited to US$135,000 per passenger. The Group believes that it maintains adequate insurance coverage for the maximum civil liability that can be imposed in respect of injuries to passengers under Chinese law, the Warsaw Convention or any separate agreement applicable to the Group.

The CAAC allocates insurance premiums payable in respect of the PICC master policy to each participating airline based on the value of the airline s insured aircraft or, in the case of leased aircraft, based on the amount required by the terms of the lease. Insurance claims made by any participating airline may cause the premiums paid by the Group under the PICC master policy to increase. PICC s practice has been to reinsure a substantial portion of its aircraft insurance business through reinsurance brokers on the London reinsurance market.

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Intellectual Property

The Group s businesses and operations, other than the businesses and operations of Xiamen Airlines, are conducted under the names China Southern and China Southern Airlines in both English and Chinese. The Group uses as its logo a stylized rendition of a kapok plant. Xiamen Airlines conducts its businesses and operations under the name of Xiamen Airlines in English and Chinese and uses its own logo depicting a stylized rendition of an egret.

The names China Southern and China Southern Airlines contain Chinese words of common usage and are therefore not eligible for registration as tradenames under current Chinese law. The kapok logo is a trademark registered in China and recorded with the International Air Transport Association (IATA), the rights to which are owned by CSAHC. The Company and CSAHC have entered into a trademark license agreement (the Trademark License Agreement), pursuant to which CSAHC has licensed to the Group the right to use the names China Southern and China Southern Airlines in both English and Chinese and granted the Company a 10-year renewable license from 1997 to use the kapok logo on a world-wide basis. CSAHC has retained the right to use the kapok logo in connection with its non-airline related businesses conducted as of the date of the Trademark License Agreement and to permit its affiliates that do not compete, directly or indirectly, with the Group to use the kapok logo. Xiamen Airlines owns all rights to its egret logo, which is a trademark registered in China, and recorded with the IATA.

The Company owns all rights to three trademarks, being SKY PEARL CLUB, the logo relating to Easy Cargo 5000 and SKY PEARL CARD which are registered in China, and recorded with Trademark Office of the State Administration for Industry and Commerce. Zhuhai Airlines Company Limited owns all rights to the airline logo which is registered with the Trademark Office of the State Administration for Industry and Commerce.

Organizational Structure

The following chart illustrates the corporate structure of the Group as of year end 2005 and the aggregate effective equity interest of the Company in each of its principal subsidiaries, affiliated companies and jointly controlled entities.

Note a: Another 26% ownership interest is held by CSA s subsidiaries.

The particulars of the Company s principal subsidiaries as of December 31, 2005 are as follows:

Name of company	Place and date of establishment /operation	Proportion of ownership interest held by the Company
Guangxi Airlines Company Limited	PRC April 28, 1994	95
Southern Airlines (Group) Shantou Airlines Company Limited	PRC July 20, 1993	60
Zhuhai Airlines Company Limited	PRC May 8, 1995	60
Xiamen Airlines Company Limited	PRC August 11, 1984	60
Guizhou Airlines Company Limited	PRC November 12, 1991	60
Guangzhou Air Cargo Company Limited	PRC March 31, 2004	70
Guangzhou Nanland Air Catering Company Limited	PRC November 21, 1989	75
China Southern West Australian Flying College Pty Ltd.	Australia January 26, 1971	65
Guangzhou Baiyun International Logistic Company Ltd	PRC July 23, 2002	61
Xinjiang Civil Aviation Property Management Limited	PRC February 12, 2002	51.8

Affiliated Companies and Jointly Controlled Entities

The particulars of the Group s principal affiliated companies and jointly controlled entity as of December 31, 2005 are as follows:

Name of company	Place and date of establishment /operation	Proportion of ownership interest held by Group effective interest	The Company	Subsidiaries
Guangzhou Aircraft Maintenance Engineering Company Limited	PRC October 28, 1989	50	50	
China Southern Airlines Group Finance Company Limited	PRC June 28, 1995	49.3	32	26
Sichuan Airlines Corporation Limited	PRC August 28, 2002	39	39	
China Postal Airlines Limited	PRC November 25, 1996	49	49	
MTU Maintenance Zhuhai Co. Ltd	PRC April 6, 2001	50	50	
Zhuhai Xiang Yi Aviation Technology Company Limited	PRC July 10, 2002	51	51	
		50	50	

Beijing Southern Airlines Ground Service Company Limited	PRC April 1, 2004

Certain of the Company s subsidiaries, affiliated companies and jointly controlled entities are PRC joint ventures which have limited duration pursuant to PRC law.

Property, Plant and Equipment

For a discussion of the Group s aircraft, see Item 4, Information on the Company History and development of the Company Aircraft Fleet.

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The Group s headquarters in Guangzhou occupy an area of approximately 149,000 square meters of land and a total gross floor area of approximately 149,000 square meters. The Group leases from CSAHC the land in Guangzhou on which the Group s headquarters and other facilities are located. The Group also leases from CSAHC certain buildings at the Wuhan and Haikou airports.

The Company s principal properties are located at its headquarters site and at its route bases. The following table sets forth certain information with respect to the Company s properties at its headquarters in Guangzhou and certain route bases as of the date hereof.

	Land (in square meters)		Buildings (in square meters)	
	Owned	Leased	Owned	Leased
Guangzhou	9,797	80,809	514,957	1,755
Shenzhen	208,740		54,093	
Zhuhai	170,062		18,791	
Changsha	138,949		47,190	
Zhengzhou	290,841		60,582	
Haikou	5,265		63,570	19,633
Wuhan		31,061	17,335	
Nanyang			12,156	

The following table sets forth certain information with respect to the properties of the Airline Subsidiaries as of the date hereof.

	Land (in square meters)		Buildings (in square meters)	
	Owned	Leased	Owned	Leased
Xiamen	451,121		355,038	12,509
Shantou	36,931	55,407	40,624	
Zhuhai	68,186		54,398	2,135
Guilin	72,563		73,379	139
Guizhou	259,879		93,390	3,533

As systems for registration and transfer of land use rights and related real property interests in China have been implemented relatively recently, such systems do not yet comprehensively account for all land and related property interests. The land in Guangzhou on which the Group s headquarters and other facilities are located and the buildings that the Group uses at its route base in Wuhan and Haikou are leased by the Company from CSAHC. However, CSAHC lacks adequate documentation evidencing CSAHC s rights to such land and buildings, and, as a consequence, the lease agreements between CSAHC and the Company for such land may not be registered with the relevant authorities. Lack of registration may affect the validity of such lease agreements. There are certain other parcels of land and buildings owned or used by the Group that lack adequate documentation. Lack of adequate documentation for land use rights and ownership of buildings may impair the ability of the Group to dispose of or mortgage such land use rights and buildings.

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS.

The following discussion and analysis should be read in conjunction with the Financial Statements of the Group contained elsewhere in this Annual Report. The Group maintains its books and accounts in accordance with PRC Accounting Rules and Regulations (PRC GAAP) and prepares its financial statements in accordance with both PRC GAAP and IFRS. The Financial Statements contained elsewhere in this Annual Report have been prepared in accordance with IFRS. IFRS differs in certain significant respects from U.S. GAAP. Information relating to the nature and effect of such differences is presented in Note 51 to the Financial Statements.

Certain IFRS comparative figures have been restated as a result of the changes in accounting policies. For details, please refer to item 3.

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Critical Accounting Policies

The discussion and analysis of the Group s financial condition and results of operations are based upon the consolidated financial statements, which have been prepared in accordance with IFRS. The preparation of such consolidated financial statements requires the Group to make estimates and judgments that affect the reported amount of assets and liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities at the date of the consolidated financial statements. Actual results may differ from these estimates under different assumptions or conditions.

Critical accounting policies are defined as those that are reflective of significant judgments and uncertainties, and potentially result in materially different results under different assumptions and conditions. The Group believes that its critical accounting policies are limited to those described below. For a detailed discussion on the application of these and other accounting policies, see Note 2 to the Financial Statements.

Revenue Recognition

The Group records sales of passenger, cargo and mail tickets as Sales in advance of carriage , a current liability, on the consolidated balance sheet. Passenger, cargo and mail revenues are recognized and the related current liability is reduced when the transportation is provided. Sales in advance of carriage therefore represents ticket sold for future travel dates and estimated future refunds and exchanges of tickets sold for past travel dates. The Group s balance of sales in advance of carriage as of December 31, 2005 was RMB1,413 million.

Property, plant and equipment

The Group has approximately RMB54,266 million fixed assets as of December 31, 2005. In addition to the original cost of these assets, their recorded value is impacted by a number of policy elections, including the estimation of useful lives and residual values and when necessary, impairment charges.

There were no significant changes to the original estimated useful lives or residual values of the property, plant and equipment of the Group during 2003, 2004 and 2005. The Group records aircraft at acquisition cost. Depreciable life is determined through economic analysis, reviewing existing fleet plans, recommendations from manufacturers and comparing estimated lives to other airlines that operate similar fleets. Residual values are estimated based on our historical experience with regards to the sale of aircraft and are established in conjunction with the estimated useful lives of the aircraft. Residual values are based on current dollars when the aircraft are acquired and typically reflect asset values that have not reached the end of their physical life. Both depreciable lives and residual values are reviewed periodically to recognize changes in our fleet plan and changes in conditions.

In addition, the Group evaluates fixed assets used in operations for impairment. Under IFRS, if circumstances indicate that the net book value of an asset may not be recoverable, this asset may be considered impaired , and an impairment loss may be recognized in accordance with IAS 36 Impairment of Assets . The amount of impairment loss is the difference between the carrying amount of the asset and its recoverable amount. The recoverable amount is the greater of the net selling price and the value in use. In determining the value in use, the Group utilizes certain assumptions, including, but not limited to: (i) estimated fair market value of the assets, and (ii) estimated future cash flows expected to be generated by these assets, which are based on additional assumptions such as asset utilization, length of service the asset will be used in the Group s operations and estimated residual values. The Group will use all readily available information in determining an amount that is a reasonable approximation of recoverable amounts, including estimates based on industry trends and reference to market rates and transactions. Changes to the above estimates may have a material effect on the Group s Financial Statements. As of December 31, 2005, based on the result of evaluation, the Group considered that no impairment is required. Under U.S. GAAP, property, plant, and equipment of the Group are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. During 2003, the impairment losses of RMB510 million was recognized on certain aircraft of CNA.

Impairment loss for doubtful accounts

The Group maintains an impairment loss for doubtful accounts for estimated losses resulting from the inability of the debtors to make required payments. The Group bases the estimates of future cash flows on the ageing of the trade receivables balance, debtors credit-worthiness, and historical write-off experience. If the financial condition of the debtors were to deteriorate, actual write-offs would be higher than estimated.

Movements in impairment losses for doubtful accounts are as follows:

	Year ended December 31,	
	2004 RMB	2005 RMB
At January 1	70	92
Impairment losses for bad and doubtful accounts	27	
Through the CNA/XJA Acquistions	44	
Bad and doubtful accounts written off	(49)	(48)
At December 31	92	44

Overview

As a result of the growth in airline market, and acquisition of the airline operations and related assets of China Northern Airlines Company (CNA) and Xinjiang Airlines Company (XJA), the Group s business benefited from the increase of transport capacity, passenger volume and cargo and mail carried. Nevertheless, the Group is facing pressure on its operation due to continuing increase of jet fuel cost and intensified competition.

With effect from July 21, 2005, China began to adopt a managed floating exchange rate system based on market supply and demand of currencies, which is subject to adjustments with reference to a basket of currencies. The exchange rate of Renminbi (RMB) would no longer be pegged to the US dollar only and a more flexible exchange rate system was established. The exchange rate of U.S. dollar and RMB was at USD1.00: RMB8.11. Because the Group finances its aircraft acquisitions mainly through finance leases or bank loans in U.S. dollars, and there are a substantial amount of transactions and obligations denominated in U.S. dollars in relation to its global purchase of jet fuel, lease and purchase of aviation equipment as well as major repairs, in addition to the landing fees of its international flights in the airports of other countries, the Group benefited from the RMB appreciation. RMB appreciation has brought a one-off exchange gain to the Group and reduced its operating costs which are denominated in foreign currencies. On the other hand, RMB appreciation will also present the Group with a challenge in price competition in international route operations.

According to the Notice of the National Development and Reform Commission (NDRC) and the Civil Aviation Administration of China (CAAC) on Issues Relating to Introduction of the Fuel Surcharge for Domestic Routes, domestic airlines imposed fuel surcharges for all the domestic routes (excluding those from the mainland PRC to Hong Kong and Macau) with effect from August 1, 2005 (based on flight time). On February 16, 2006, the NDRC and CAAC released a supplementary document on Issues Relating to the Introduction of Fuel Surcharge for Domestic Routes, stating that due to the rising jet fuel price, the period of imposition of fuel surcharge by airlines was extended. On March 28, 2006, the NDRC and CAAC released another supplementary document on Issues Relating to the Introduction of Fuel Surcharge for Domestic Routes, thereby adjusting the amount of fuel surcharges from RMB20 to RMB30 per passenger for distance flown being less than 800 kilometres, and from RMB40 to RMB60 for distance exceeding 800 kilometres, during the period temporarily from April 10, 2006 to October 10, 2006. The introduction of fuel surcharge and the extension of the duration of the same will help relieve, to a certain extent, the burden of high jet fuel cost on the Group.

The Group s operating revenue is substantially dependent on the passenger and cargo traffic volume carried, which is subject to seasonal and other changes in traffic patterns, the availability of appropriate time slots for the Group s flights and alternative routes, the degree of competition from other airlines and alternate means of transportation, as well as other factors that may influence passenger travel demand and cargo and mail volume. In particular, the Group s airline revenue is generally higher in the second and third quarters than in the first and fourth quarters.

Like most airlines, the Group is subject to a high degree of financial and operating leverage. A significant percentage of the Group s operating expenses is fixed costs that do not vary proportionally based on the Group s yields or the load factors. These fixed costs include depreciation expense, jet fuel costs, landing and navigation fees, financing costs, operating lease payments, aircraft maintenance costs and labor for flight crew, cabin crew and ground personnel. Thus, a minor change in the Group s yields or load factors would have a material effect on the Group s results of operations. In addition, certain of these expenses, primarily financing costs and operating lease payments, labor costs and depreciation do not vary based on the number of flights flown. Thus, the Group s operating results can also be substantially affected by minor changes in aircraft utilization rates. The Group is and will continue to be highly leveraged with substantial obligations denominated in foreign currencies and, accordingly, the results of its operations are significantly affected by fluctuations in foreign exchange rates, particularly for the U.S. dollar and the Japanese yen. The Group recognized a net exchange loss of RMB59 million and net exchange gain of RMB1,220 million in 2004 and 2005, respectively. These amounts represented mainly unrealized exchange differences resulting from the retranslation of the foreign currency borrowings.

A number of other external variables, including political and economic conditions in China, tend to have a major impact on the Group s performance. The Group s financial performance is also significantly affected by factors arising from operating in a regulated industry. As substantially all aspects of the Group s airline operations are regulated by the PRC government, the Group s operating revenues and expenses are directly affected by the PRC government s policies with respect to domestic airfares, jet fuel prices and landing and navigation fees, among others. The nature and extent of airline competition and the ability of Chinese airlines to expand are also affected by CAAC s control

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over route allocations. Any changes in the PRC government s regulatory policies, or any implementation of such policies could have a significant impact on the Group s future operations and its ability to implement its operating strategy.

Certain Financial Information and Operating Data by Geographic Region

The following table sets forth certain financial information and operating data by geographic region for the years ended December 31, 2003, 2004 and 2005:

	Year ended December 31, 2003	2004	2005	2004 vs. 2003 % increase/ (decrease)	2005 vs. 2004 % increase/ (decrease)
Traffic					
RPK (million)					
Domestic	21,294	29,121	51,472	36.8	76.8
Hong Kong and Macau	778	1,203	1,549	54.6	28.8
International	4,315	6,872	8,902	59.3	29.5
Total	26,387	37,196	61,923	41.0	66.5
RTK (million)					
Domestic	2,424	3,206	5,571	32.3	73.8
Hong Kong and Macau	78	120	159	53.8	32.5
International	1,059	1,337	1,554	26.3	16.2
Total	3,561	4,663	7,284	30.9	56.2
Passengers carried (thousand)					
Domestic	18,259	25,002	39,545	36.9	58.2
Hong Kong and Macau	1,019	1,394	1,556	36.8	11.6
International	1,192	1,811	3,018	51.9	66.6
Total	20,470	28,207	44,119	37.8	56.4
Cargo and mail carried (thousand tons)					
Domestic	379	442	639	16.6	44.6
Hong Kong and Macau	12	15	19	25.0	26.7
International	73	88	117	20.5	33.0
Total	464	545	775	17.5	42.2

	Year ended December 31, 2003	2004	2005	2004 vs. 2003 % increase/ (decrease)	2005 vs. 2004 % increase/ (decrease)
Capacity					
ASK (million)					
Domestic	32,590	41,330	72,107	26.8	74.5
Hong Kong and Macau	1,347	1,896	2,656	40.8	40.1
International	6,930	10,543	13,598	52.1	29.0
Total	40,867	53,769	88,361	31.6	64.3
ATK (million)					
Domestic	3,772	4,773	8,352	26.5	75.0
Hong Kong and Macau	150	211	315	40.7	49.3
International	1,999	2,462	2,842	23.2	15.4
Total	5,921	7,446	11,509	25.8	54.6
Load Factors					

Passenger load factor (RPK/ASK) (%)					
Domestic	65.3	70.5	71.4	8.0	1.3
Hong Kong and Macau	57.8	63.4	58.3	9.7	(8.0)
International	62.3	65.2	65.5	4.7	0.5
Overall	64.6	69.2	70.1	7.1	1.3
Overall load factor (RTK/ATK) (%)					
Domestic	64.2	67.2	66.7	4.7	(0.7)
Hong Kong and Macau	52.2	56.9	50.4	9.0	(11.4)
International	53.0	54.3	54.7	2.5	0.7
Overall	60.1	62.6	63.3	4.2	1.1
Yield					
Yield per RPK (RMB)					
Domestic	0.57	0.58	0.55	1.8	(5.2)

	2003	Year ended December 31, 2004	2005	2004 vs. 2003 % increase/ (decrease)	2005 vs. 2004 % increase/ (decrease)
Hong Kong and Macau	0.96	0.92	0.77	(4.2)	(16.3)
International	0.47	0.46	0.56	(2.1)	21.7
Overall	0.57	0.57	0.55		(3.5)
Yield per RTK (RMB)					
Domestic	5.40	5.53	5.30	2.4	(4.2)
Hong Kong and Macau	10.35	9.83	8.18	(5.0)	(16.8)
International	2.90	3.31	4.24	14.1	28.1
Overall	4.76	5.01	5.14	5.3	2.6
Financial IFRS					
Passenger revenue (RMB million)					
Domestic	12,242	16,869	28,182	37.8	67.1
Hong Kong and Macau	750	1,104	1,194	47.2	8.2
International	2,018	3,127	4,952	55.0	58.4
Total	15,010	21,100	34,328	40.6	62.7
Cargo and mail revenue (RMB million)	1,955	2,244	3,091	14.8	37.7
U.S. GAAP					
Passenger revenue (RMB million)					
Domestic	18,679	24,773	28,182	32.6	13.8
Hong Kong and Macau	781	1,151	1,194	47.4	3.7
International	2,978	4,519	4,952	51.7	9.6
Total	22,438	30,443	34,328	35.7	12.8
Cargo and mail revenue (RMB million)	2,459	2,792	3,091	13.5	10.7

Operating Results

The historical results of operations discussed below may not be indicative of the Group s future operating performance. In addition to the factors discussed under Overview above, the Group s future operations will be affected by, among other things, changes in the aviation market, the cost of jet fuel, aircraft acquisition and leasing costs, aircraft maintenance expenses, take-off and landing charges, wages, salaries and benefits and other operating expenses, foreign exchange rates and the rates of income taxes paid.

2005 Compared with 2004

The loss for 2005 attributable to equity shareholders of the Company is RMB1,848 million, as compared to a loss of RMB48 million for 2004. The scale of operations increased as a result of acquisition of the airline operations and related assets of CNA and XJA on December 31, 2004. The Group s operating revenue increased by RMB14,319 million or 59.7% from RMB23,974 million in 2004 to RMB38,293 million in 2005. Passenger load factor increased by 0.9 percentage point from 69.2% in 2004 to 70.1% in 2005. Passenger yield (in passenger revenue per RPK) decreased slightly by 3.5% to RMB0.55. Average yield (in traffic revenue per RTK) increased by 2.6% from RMB5.01 in 2004 to RMB5.14 in 2005. Operating expenses increased by RMB16,533 million or 71.7% from RMB23,065 million in 2004 to RMB39,598 million in 2005. As the increase in operating revenue is smaller than the increase in operating expenses, operating profit decreased by 243.6% from an operating profit of RMB909 million in 2004 to an operating loss of RMB1,305 million in 2005. The Group s net non-operating expenses decreased by 20.5%, from RMB689 million in 2004 to RMB548 million in 2005, mainly attributable to the combined effect of increase in exchange gain of RMB1,279 million, increase in interest expense of RMB925 million and a decrease in share of results of associates of RMB295 million.

Operating revenue

Substantially all of the Group s operating revenue is attributable to airline and airline related operations. Traffic revenue accounted for 97.7% and 97.4% of total operating revenue in 2005 and 2004 respectively. Passenger revenue and, cargo and mail revenue accounted for 91.7% and 8.3% respectively of total traffic revenue in 2005. The other operating revenue is mainly derived from commission income, income from general aviation operations, fees charged for ground services rendered to other Chinese airlines and air catering services.

Operating revenue increased by 59.7% from RMB23,974 million in 2004 to RMB38,293 million in 2005. The increase was primarily due to a 62.7% rise in passenger revenue from RMB21,100 million in 2004 to RMB34,328 million in 2005 resulting from increased traffic volume. The total number of passengers carried increased by 56.4% to 44.12 million passengers and the ASKs increased by 64.3% to 88,361 million in 2005. The increase in 2005 compared to 2004 was attributable to the general increasing traffic demand in the PRC airline market and deliveries of 108 aircraft during 2005 which caused an increase in passenger capacity of 68.1%.

Passenger yield decreased slightly by RMB0.02. RPKs increased by 66.5% from 37,196 million in 2004 to 61,923 million in 2005, primarily as a result of the increase in passengers carried.

Domestic passenger revenue, which accounted for 82.1% of the total passenger revenue in 2005, increased by 67.1% from RMB16,869 million in 2004 to RMB28,182 million in 2005. Domestic passenger traffic in RPKs increased by 76.8%, mainly due to an increase in passengers carried. Domestic passenger yield decreased slightly by RMB0.03 to RMB0.55 in 2005.

Hong Kong and Macau passenger revenue, which accounted for 3.5% of total passenger revenue, increased by 8.2% from RMB1,104 million in 2004 to RMB1,194 million in 2005. For Hong Kong and Macau flights, passenger traffic in RPKs increased by 28.8%, while passenger capacity in ASKs increased by 40.1%, resulting in a 5.1 percentage point decrease in passenger load factor from 2004. Passenger yield decreased from RMB0.92 in 2004 to RMB0.77 in 2005 mainly due to intensified competition among airlines.

International passenger revenue, which accounted for 14.4% of total passenger revenue, increased by 58.4% from RMB3,127 million in 2004 to RMB4,952 million in 2005. For international flights, passenger traffic in RPKs increased by 29.5%, while passenger capacity in ASKs increased by 29.0%, resulting in a 0.3 percentage point rise in passenger load factor from 2004. Passenger yield increased by 21.7% from RMB0.46 in 2004 to RMB0.56 in 2005 mainly resulted from higher ticket price and the increases in traffic derived from short haul routes which generally had a higher yield than long haul routes.

Cargo and mail revenue, which accounted for 8.3% of the Group s total traffic revenue and 8.1% of total operating revenue, increased by 37.7% from RMB2,244 million in 2004 to RMB3,091 million in 2005. The increase was attributable to the increasing traffic demand.

Other operating revenue increased by 38.7% from RMB630 million in 2004 to RMB874 million in 2005. The increase was primarily due to the general growth in income from various auxiliary operations.

Operating expenses

Total operating expenses in 2005 amounted to RMB39,598 million, representing an increase of 71.7% or RMB16,533 million over 2004, primarily due to the total effect of increases in jet fuel costs, maintenance expenses and aircraft and traffic servicing expenses. Total operating expenses as a percentage of total operating revenue increased from 96.2% in 2004 to 103.4% in 2005.

Flight operations expenses, which accounted for 49.0% of total operating expenses, increased by 86.2% from RMB10,418 million in 2004 to RMB19,394 million in 2005, primarily as a result of increases in jet fuel costs, operating lease payments, catering expenses and labour costs for flight personnel. Jet fuel costs, which accounted for 61.5% of flight operations expenses, increased by 97.2% from RMB6,050 million in 2004 to RMB11,929 million in 2005 mainly as a result of increased fuel prices and fuel consumption. Operating lease payments increased by 50.0% from RMB1,665 million in 2004 to RMB2,497 million in 2005 primarily due to the additional rental payments for new aircraft under operating leases. Catering expenses increased by 69.6% from RMB705 million in 2004 to RMB1,196 million in 2005 due to the increase in number of passengers carried. Aircraft insurance costs decreased by 43.2% from RMB185 million in 2004 to RMB105 million in 2005, mainly because of the decrease in insurance premiums in 2005. Labour costs for flight personnel increased by 57.8% from RMB1,026 million in 2004 to RMB1,619 million in 2005, largely due to the increase in flying hours and allowance standard.

Maintenance expenses which accounted for 11.6% of total operating expenses, increased by 32.7% from RMB3,459 million in 2004 to RMB4,589 million in 2005. The increase was mainly attributable to the fleet expansion in recent years.

Aircraft and traffic servicing expenses, which accounted for 14.5% of total operating expenses, increased by 64.4% from RMB3,503 million in 2004 to RMB5,759 million in 2005. The increase primarily resulted from a 51.8% rise in landing and navigation fees from RMB3,222 million in 2004 to RMB4,891 million in 2005, due to an increase in number of landing and takeoffs.

Promotional and marketing expenses, which accounted for 7.0% of total operating expenses, increased by 43.3% from RMB1,940 million in 2004 to RMB2,780 million in 2005. The increase was mainly resulted from the increase in sales volume, resulting in a 41.5% increase in sales commission expenses from RMB1,062 million in 2004 to RMB1,503 million in 2005.

General and administrative expenses, which accounted for 6.2% of the total operating expenses, increased by 85.7% from RMB1,323 million in 2004 to RMB2,457 million in 2005. This was mainly attributable to increased scale of operations.

Depreciation and amortisation, which accounted for 11.2% of total operating expenses, increased by 84.0% from RMB2,413 million in 2004 to RMB4,440 million in 2005, mainly resulting from the additional depreciation charge on aircraft delivered in 2004 and 2005.

Operating(loss))/Profit

There is an operating loss of RMB1,305 million in 2005 as compared to an operating profit of RMB909 million in 2004. This was mainly because operating revenue increased by RMB14,319 million or 59.7% in 2005 while operating expenses increased by RMB16,533 million or 71.7% in the same period.

Non-operating income/(expenses)

Interest expense increased by 133.9% from RMB691 million in 2004 to RMB1,616 million in 2005, mainly due to the increase in loans and lease obligations and interest rate. Interest income increased by 150.0% from RMB22 million in 2004 to RMB55 million in 2005, mainly attributable to the increase of interest rate.

During 2005, the Group recorded a net exchange gain of RMB1,220 million (2004: Net exchange loss of RMB59 million) mainly resulted from Renminbi appreciation in July 2005. Such amount represents mainly unrealised translation exchange gain, resulting from exchange gains on translated year end foreign currency denominated liabilities, rather than foreign exchange transactions incurred during the year.

Taxation

The statutory income tax rate in the PRC is 33%. Except for certain branches and subsidiaries, the Company and its subsidiaries are entitled to enjoy a preferential tax rate of 15% pursuant to approval documents issued by the relevant tax authorities.

In 2005, the Group recorded an income tax benefit of RMB7 million and actual effective tax rate was 0.4% while the Group s enacted tax rate is 15%. The difference is mainly due to the fact that a portion of tax loss is not recognized, the deferred tax effect of which is RMB135 million. In 2004, income tax expense of RMB65 million was recorded and actual effective tax rate was 30% while the Group s enacted tax rate in 2004 was 15%. The difference is mainly due to the tax effect of non-deductible expenses of RMB29 million.

2004 Compared with 2003

The Group recorded a net loss of RMB48 million attributable to equity shareholder for 2004, as compared to a net loss of RMB358 million attributable to equity shareholder for 2003. The Group s operating revenue increased by RMB6,504 million or 37.2% from RMB17,470 million in 2003 to RMB23,974 million in 2004. Passenger load factor increased by 4.6 percentage point from 64.6% in 2003 to 69.2% in 2004. Passenger yield (in passenger revenue per RPK) remain steady and at RMB0.57 in both years. Average yield (in traffic revenue per RTK) increased by 5.3% from RMB4.76 in 2003 to RMB5.01 in 2004. Operating expenses increased by RMB6,051 million or 35.6% from RMB17,014 million in 2003 to RMB23,065 million in 2004. As operating revenue increased more than operating expenses, operating profit increased by 99.3% from RMB456 million in 2003 to RMB909 million in 2004. The Group s net non-operating expenses decreased by 30.1%, from RMB967 million in 2003 to RMB676 million in 2004, mainly attributable to a decrease in unfavourable movement in foreign exchange differences of RMB105 million and a decrease in interest expense of RMB133 million. Overall, the Group recorded a net loss of RMB48 million in 2004, as compared to a net loss of RMB358 million in 2003.

Operating revenue

Substantially all of the Group s operating revenue is attributable to airline and airline related operations. Traffic revenue in 2004 and 2003 accounted for 97.4% and 97.1% respectively of total operating revenue. Passenger revenue and, cargo and mail revenue accounted for 90.4% and 9.6% respectively of total traffic revenue in 2004. The balance of the Group s operating revenue is derived

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from commission income, income from general aviation operations, fees charged for ground services rendered to other Chinese airlines and air catering services.

Operating revenue increased by 37.2% from RMB17,470 million in 2003 to RMB23,974 million in 2004. This increase was primarily due to a 40.6% rise in passenger revenue from RMB15,010 million in 2003 to RMB21,100 million in 2004 resulting from increased traffic volume. The PRC airline industry has fully recovered from the outbreak of severe acute respiratory syndrome (SARS) in China since August 2003. Coupling with the continued growth in domestic economic conditions, the aviation traffic volume in China attained a new highest record in 2004. The total number of passengers carried increased by 37.8% to 28.2 million passengers in 2004. The increase in 2004 compared to 2003 was attributable to the general increasing traffic demand in the PRC airline market and deliveries of 20 aircraft (excluding effect of CNA/XJA Acquisitions) during 2004 which caused an increase in passenger capacity of 31.6%. RPKs increased by 41.0% from 26,387 million in 2003 to RMB37,196 million in 2004, primarily as a result of an increase in passengers carried. Passenger yield remained constant at RMB0.57.

Domestic passenger revenue, which accounted for 79.9% of the total passenger revenue in 2004, increased by 37.8% from RMB12,242 million in 2003 to RMB16,869 million in 2004. Domestic passenger traffic in RPKs increased by 36.8%, mainly due to an increase in passengers carried. Passenger yield remained steady in 2004 and at RMB0.58. Included in the 2004 domestic passenger revenue was fuel surcharge imposed on domestic flights of approximately RMB281 million (2003: RMB716 million). Excluding the effect of fuel surcharge revenue, the passenger yield increased from RMB0.54 in 2003 to RMB0.57 in 2004 as a combined result of the growth in traffic demand and fleet expansion during 2004.

Hong Kong passenger revenue, which accounted for 5.3% of total passenger revenue, increased by 47.2% from RMB750 million in 2003 to RMB1,104 million in 2004. For Hong Kong regional flights, passenger traffic in RPKs increased by 54.6%, while passenger capacity in ASKs increased by 40.8%, resulting in a 5.6 percentage point increase in passenger load factor from 2003. Passenger yield decreased from RMB0.96 in 2003 to RMB0.92 in 2004 mainly due to intensified competition among airlines. Included in 2004 Hong Kong passenger revenue was fuel surcharge imposed on Hong Kong regional flights of approximately RMB67 million (2003: RMB24 million). Excluding the effect of fuel surcharge revenue, the passenger yield decreased from RMB0.93 in 2003 to RMB0.86 in 2004.

International passenger revenue, which accounted for 14.8% of total passenger revenue, increased by 55.0% from RMB2,018 million in 2003 to RMB3,127 million in 2004. For international flights, passenger traffic in RPKs increased by 59.3%, while passenger capacity in ASKs increased by 52.1%, resulting in a 2.9 percentage point rise in passenger load factor from 2003. Passenger yield decreased by 2.1% from RMB0.47 in 2003 to RMB0.46 in 2004 mainly resulted from the increases in traffic derived from long haul routes which generally had a lower yield than short haul routes.

Cargo and mail revenue, which accounted for 9.6% of the Group s total traffic revenue and 9.4% of total operating revenue, increased by 14.8% from RMB1,955 million in 2003 to RMB2,244 million in 2004. The increase was attributable to the increasing traffic demand.

Other operating revenue increased by 24.8% from RMB505 million in 2003 to RMB630 million in 2004. The increase was primarily due to the general growth in income from various auxiliary operations.

Operating expenses

Substantially all of the Group s operating expenses result from its airline operations. The vast majority of such expenses relate directly to flight operations, aircraft and traffic servicing, aircraft repair and maintenance and to depreciation and amortisation in respect of aircraft and flight equipment. Expenses associated directly with the Group s flight operations (collectively, flight operations expenses) include fuel costs, operating lease payments, catering expenses, aircraft insurance, flight personnel payroll and welfare and training expenses. Expenses associated directly with repairs and maintenance in respect of the Group s aircraft (collectively, repairs and maintenance expenses) include repairs and maintenance and overhaul charges, the costs of consumables and other maintenance materials and labour costs for maintenance personnel. Expenses associated directly with the Group s aircraft and traffic servicing operations (collectively aircraft and traffic servicing expenses) include landing and navigation fees, rental payments and charges in respect of terminal and other ground facilities and labour costs for ground personnel. The balance of the Group s operating expenses result from promotional and marketing activities (collectively, promotional and marketing expenses) such as sales commissions, fees for use of the CAAC s reservation system, ticket-printing and sales office expenses, advertising and promotional expenses, and from general and administrative expenses, such as administrative salaries and welfare and other personnel benefits and office expenses.

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Total operating expenses in 2004 amounted to RMB23,065 million, representing an increase of 35.6% or RMB6,051 million over 2003, primarily due to the combined effect of increases in jet fuel costs, maintenance expenses and aircraft and traffic servicing expenses. Total operating expenses as a percentage of total operating revenue decreased from 97.4% in 2003 to 96.2% in 2004.

Flight operations expenses, which accounted for 45.2% of total operating expenses, increased by 47.4% from RMB7,070 million in 2003 to RMB10,418 million in 2004, primarily as a result of increases in jet fuel costs, operating lease payments, catering expenses, labour costs for flight personnel and inclusion of CAAC Infrastructure Development Fund of RMB466 million in operating expenses which is an usage charge since 2004 but was a turnover-based levy and deducted against the traffic revenue in 2003. Jet fuel costs, which accounted for 58.1% of flight operations expenses, increased by 56.5% from RMB3,867 million in 2003 to RMB6,050 million in 2004 mainly as a result of increased fuel prices and fuel consumption. Operating lease payments increased by 8.4% from RMB1,536 million in 2003 to RMB1,665 million in 2004, primarily due to the additional rental payments for new aircraft under operating leases. Catering expenses increased by 38.2% from RMB510 million in 2003 to RMB705 million in 2004, primarily due to increased passenger carried. Aircraft insurance costs decreased by 5.6% from RMB196 million in 2003 to RMB185 million in 2004, primarily because of a decrease in insurance premiums prescribed by the PRC insurance company. Labour costs for flight personnel increased by 40.9% from RMB728 million in 2003 to RMB1,026 million in 2004, largely due to the increase in flying hours.

Maintenance expenses which accounted for 15.0% of total operating expenses, increased by 33.6% from RMB2,589 million in 2003 to RMB3,459 million in 2004. The increase was primarily attributable to an 32.9% increase in aircraft overhaul charges from RMB2,377 million in 2003 to RMB3,158 million in 2004, as resulted from fleet expansion in recent years.

Aircraft and traffic servicing expenses, which accounted for 15.2% of total operating expenses, increased by 26.6% from RMB2,767 million in 2003 to RMB3,503 million in 2004. The increase primarily resulted from an 25.7% rise in landing and navigation fees from RMB2,563 million in 2003 to RMB3,222 million in 2004, due to an increase in number of landing and takeoffs.

Promotional and marketing expenses, which accounted for 8.4% of total operating expenses, increased by 31.1% from RMB1,480 million in 2003 to RMB1,940 million in 2004. The increase was due to 44.4% increase in labour costs from RMB225 million in 2003 to RMB325 million in 2004, as more payments of performance bonus were made because of the increased traffic volume.

General and administrative expenses, which accounted for 5.7% of the total operating expenses, increased by 25.6% from RMB1,053 million in 2003 to RMB1,323 million in 2004. This was mainly attributable to increased scale of operations.

Depreciation and amortisation, which accounted for 10.5% of total operating expenses, increased by 18.4% from RMB2,038 million in 2003 to RMB2,413 million in 2004. This increase was primarily as a result of the additions of aircraft during 2004.

Operating profit

Operating profit increased by 99.3% from RMB456 million in 2003 to RMB909 million in 2004. This was mainly because operating revenue increased by RMB6,504 million or 37.2% from 2003 and operating expenses increased by RMB6,051 million or 35.6% over the same period.

Non-operating income/(expenses)

Interest expense decreased by 16.1% from RMB824 million in 2003 to RMB691 million in 2004, mainly reflecting the combined effect of scheduled debt repayments and the replacement of certain RMB denominated bank loans of higher interest rates with US$ denominated bank loans of lower interest rates.

Interest income increased by 69.2% from RMB13 million in 2003 to RMB22 million in 2004. This was mainly attributable to an increase in average cash balances.

During 2004, the Group recorded a net exchange loss of RMB59 million (2003:RMB164 million) mainly from its Japanese yen denominated borrowings as a result of the Japanese yen appreciation. Such amount comprised mostly unrealised translational exchange loss.

Taxation

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On October 17, 2003, the Company s registered address was moved to Guangzhou Economic & Technology Development Zone, Guangzhou, China. In accordance with the Rules and Regulations for Implementation of Income Tax for Foreign Investment Enterprises and Foreign Enterprises of the PRC and a taxation approval document Guangzhou Municipal State Tax Bureau Suo De Shui Zi Que 020043 , the Company is entitled to enjoy the preferential tax policy implemented in the Guangzhou Economic & Technology Development Zone effective from October 1, 2003. As a result, the Company s income tax rate has been changed from 33% to 15% beginning from that date.

In 2003, the Group recorded an income tax benefit of RMB334 million resulting from reduction in net deferred taxation liability balance of RMB392 million. In 2004, income tax expense of RMB65 million was recorded.

Minority interests

Minority interests increased by 18.7% from RMB171 million in 2003 to RMB203 million in 2004, primarily reflecting the increased net profits earned by certain of the Group s airline subsidiaries for the year.

Additional information under U.S. GAAP

2005 Compared with 2004

The loss for 2005 attributable to equity shareholders of the Company is RMB1,530 million, as compared to an income of RMB239 million for 2004. The scale of operations increased as a result of acquisition of the airline operations and related assets of CNA and XJA on December 31, 2004. The Group s operating revenue increased by RMB4,128 million or 12.1% from RMB34,165 million in 2004 to RMB38,293 million in 2005. Passenger load factor increased by 1.2 percentage point from 68.9% in 2004 to 70.1% in 2005. Passenger yield (in passenger revenue per RPK) decreased slightly by 3.1% to RMB0.55. Average yield (in traffic revenue per RTK) decreased by 1.6% from RMB5.22 in 2004 to RMB5.14 in 2005. Operating expenses increased by RMB7,097 million or 22.0% from RMB32,288 million in 2004 to RMB39,385 million in 2005. As the increase in operating revenue is smaller than the increase in operating expenses, operating income decreased by 158.2% from an operating profit of RMB1,877 million in 2004 to an operating loss of RMB1,092 million in 2005. The Group s net non-operating expenses decreased by 60.8%, from RMB1,184 million in 2004 to RMB464 million in 2005, mainly attributable to the combined effect of increase in exchange gain of RMB1,344 million, increase in interest expense of RMB405 million and a decrease in share of results of associates of RMB280 million.

Operating revenue

Substantially all of the Group s operating revenue is attributable to airline and airline related operations. Traffic revenue accounted for 97.7% and 97.3% of total operating revenue in 2005 and 2004 respectively. Passenger revenue and, cargo and mail revenue accounted for 91.7% and 8.3% and 91.6% and 8.4% respectively of total traffic revenue in 2005 and 2004 respectively. The other operating revenue is mainly derived from commission income, income from general aviation operations, fees charged for ground services rendered to other Chinese airlines and air catering services.

Operating revenue increased by 12.1% from RMB34,165 million in 2004 to RMB38,293 million in 2005. The increase was primarily due to a 12.8% rise in passenger revenue from RMB30,443 million in 2004 to RMB34,328 million in 2005 resulting from increased traffic volume. The total number of passengers carried increased by 14.0% to 44.12 million passengers and the ASKs increased by 14.3% to 88,361 million in 2005. The increase in 2005 compared to 2004 was attributable to the general increasing traffic demand in the PRC airline market and deliveries of 30 aircraft during 2005 which caused an increase in passenger capacity of 12.4%. RPKs increased by 16.3% from 53,233 million in 2004 to RMB61,923 million in 2005, primarily as a result of the increase in passengers carried. Passenger yield decreased slightly by RMB0.02 to RMB0.55.

Domestic passenger revenue, which accounted for 82.1% of the total passenger revenue in 2005, increased by 13.8% from RMB24,773 million in 2004 to RMB28,182 million in 2005. Domestic passenger traffic in RPKs increased by 17.8%, mainly due to an increase in passengers carried. Domestic passenger yield decreased slightly by RMB0.02 to RMB0.55 in 2005.

Hong Kong and Macau passenger revenue, which accounted for 3.5% of total passenger revenue, increased by 3.7% from RMB1,151 million in 2004 to RMB1,194 million in 2005. For Hong Kong and Macau flights, passenger traffic in RPKs increased by 18.5%, while passenger capacity in ASKs increased by 26.5%, resulting in a 4.0 percentage point decrease in passenger load factor from 2004. Passenger yield decreased from RMB0.88 in 2004 to RMB0.77 in 2005 mainly due to intensified competition among airlines.

International passenger revenue, which accounted for 14.4% of total passenger revenue, increased by 9.6% from RMB4,519 million in 2004 to RMB4,952 million in 2005. For international flights, passenger traffic in RPKs increased by 8.3%, while passenger capacity in ASKs increased by 5.4%, resulting in a 1.8 percentage point rise in passenger load factor from 2004. Passenger yield increased by 1.1% from RMB0.55 in 2004 to RMB0.56 in 2005.

Cargo and mail revenue, which accounted for 8.3% of the Group s total traffic revenue and 8.1% of total operating revenue, increased by 10.7% from RMB2,792 million in 2004 to RMB3,091 million in 2005. The increase was attributable to the increasing traffic demand.

Other operating revenue decreased by 6.0% from RMB930 million in 2004 to RMB874 million in 2005. The decrease was primarily due to the reduced scale of other operation.

Operating expenses

Total operating expenses in 2005 amounted to RMB39,385 million, representing an increase of 22.0% or RMB7,097 million over 2004, primarily due to the total effect of increases in jet fuel costs, maintenance expenses and aircraft and traffic servicing expenses. Total operating expenses as a percentage of total operating revenue increased from 94.5% in 2004 to 102.9% in 2005.

Flight operations expenses, which accounted for 48.7% of total operating expenses, increased by 27.8% from RMB15,016 million in 2004 to RMB19,183 million in 2005, primarily as a result of increases in jet fuel costs, operating lease payments, catering expenses and labour costs for flight personnel. Jet fuel costs, which accounted for 62.2% of flight operations expenses, increased by 39.4% from RMB8,555 million in 2004 to RMB11,929 million in 2005 mainly as a result of increased fuel prices and fuel consumption. Operating lease payments increased by 12.6% from RMB2,109 million in 2004 to RMB2,375 million in 2005 primarily due to the additional rental payments for new aircraft under operating leases. Catering expenses increased by 21.2% from RMB987 million in 2004 to RMB1,196 million in 2005 due to the increase in number of passengers carried. Aircraft insurance costs decreased by 60.8% from RMB268 million in 2004 to RMB105 million in 2005, mainly because of the decrease in insurance premiums in 2005. Labour costs for flight personnel increased by 4.8% from RMB1,545 million in 2004 to RMB1,619 million in 2005, largely due to the increase in flying hours and allowance standard.

Maintenance expenses which accounted for 11.7% of total operating expenses, increased by 0.2% from RMB4,578 million in 2004 to RMB4,589 million in 2005.

Aircraft and traffic servicing expenses, which accounted for 14.6% of total operating expenses, increased by 20.3% from RMB4,789 million in 2004 to RMB5,759 million in 2005. The increase primarily resulted from a 10.0% rise in landing and navigation fees from RMB4,447 million in 2004 to RMB4,891 million in 2005, due to an increase in number of landing and takeoffs.

Promotional and marketing expenses, which accounted for 7.1% of total operating expenses, increased by 6.7% from RMB2,606 million in 2004 to RMB2,780 million in 2005. The increase was mainly resulted from the increase in sales volume, resulting in a 17.0% increase in sales commission expenses from RMB1,285 million in 2004 to RMB1,503 million in 2005.

General and administrative expenses, which accounted for 6.2% of the total operating expenses, increased by 39.7% from RMB1,759 million in 2004 to RMB2,457 million in 2005. This was mainly attributable to increased scale of operations.

Depreciation and amortisation, which accounted for 11.2% of total operating expenses, increased by 25.1% from RMB3,523 million in 2004 to RMB4,406 million in 2005, mainly resulting from the additional depreciation charge on aircraft delivered in 2004 and 2005.

Operating (loss)/income

There is an operating loss of RMB1,092 million in 2005 as compared to an operating profit of RMB1,877 million in 2004. This was mainly because operating revenue increased by RMB4,128 million or 12.1% in 2005 while operating expenses increased by RMB7,097 million or 22.0% in the same period.

Non-operating income/(expenses)

Interest expense increased by 34.2% from RMB1,184 million in 2004 to RMB1,589 million in 2005, mainly due to the increase in loans and lease obligations and interest rate. Interest income increased by 66.7% from RMB33 million in 2004 to RMB55 million in 2005, mainly attributable to the increase of interest rate.

During 2005, the Group recorded a net exchange gain of RMB1,220 million (2004: net exchange loss of RMB124 million) mainly resulted from Renminbi appreciation in July 2005. Such amount represented mainly unrealised translation exchange gain, resulting from exchange gains on translated year end foreign currency denominated liabilities, rather than foreign exchange transactions incurred during the year.

Taxation

The statutory income tax rate in the PRC is 33%. Except for certain branches and subsidiaries, the Company and its subsidiaries are entitled to enjoy a preferential tax rate of 15% pursuant to approval documents issued by the relevant tax authorities.

Income tax benefit for the year amounted to RMB46 million and actual effective tax rate was 3% in 2005 while the Group s enacted tax rate is 15%. The difference is mainly due to a portion of tax loss with a deferred tax effect of RMB135 million not recognized as well as the effect of change in enacted income tax rate applicable to airline operations of CNA and XJA of RMB79 million. In 2004, income tax expense of RMB261 million was recorded and actual effective tax rate was 38% while the Group s enacted tax rate in 2004 was 15%. The difference is mainly due to the effect of change in enacted income tax rate applicable to airline operations of CNA and XJA of RMB99 million, rate differential on airline operations of CNA and XJA of RMB43 million and non-deductible expenses of RMB37 million.

2004 Compared with 2003

The Group s operating revenue increased by RMB8,682 million or 34.1% from RMB25,483 million in 2003 to RMB34,165 million in 2004. Such growth was primarily attributable to growth in volume of passenger traffic carried by the Group as a result of the recovery of the Group s traffic operations from SARS and flight capacity. Operating expenses increased by RMB7,171 million or 28.6% from RMB25,117 million in 2003 to RMB32,288 million in 2004. As operating revenue increased more than operating expenses, operating profit increased by 412.8% from RMB366 million in 2003 to RMB1,877 million in 2004. The Group s net non-operating expenses decreased by 38.5%, from RMB1,905 million in 2003 to RMB1,171 million in 2004, primarily attributable to a decrease in unfavourable movement in foreign exchange differences of RMB257 million and a decrease in interest expense of RMB420 million. Overall, the Group recorded a net income of RMB239 million in 2004, as compared to a net loss of RMB1,140 million in 2003.

Operating revenue

Substantially all of the Group s operating revenue is attributable to airline and airline related operations. Traffic revenue in 2004 and 2003 accounted for 97.3% and 97.7% respectively of total operating revenue. Passenger revenue and, cargo and mail revenue accounted for 91.6% and 8.4% respectively of total traffic revenue in 2004. The balance of the Group s operating revenue is derived from commission income, income from general aviation operations, fees charged for ground services rendered to other Chinese airlines and air catering services.

Operating revenue increased by 34.1% from RMB25,483 million in 2003 to RMB34,165 million in 2004. This increase was primarily due to a 35.7% rise in passenger revenue from RMB22,438 million in 2003 to RMB30,443 million in 2004 resulting from increased traffic volume. The total number of passengers carried increased by 33.0% to 38.7 million passengers in 2004. RPKs increased by 34.3% from 39,626 million in 2003 to RMB53,233 million in 2004, primarily as a result of an increase in passengers carried. Passenger yield increased to RMB0.57.

Domestic passenger revenue, which accounted for 81.4% of the total passenger revenue in 2004, increased by 32.6% from RMB18,679 million in 2003 to RMB24,773 million in 2004. Domestic passenger traffic in RPKs increased by 30.6%, mainly due to an increase in passengers carried. Passenger yield increased to RMB0.57 in 2004.

Hong Kong passenger revenue, which accounted for 3.8% of total passenger revenue, increased by 47.4% from RMB781 million in 2003 to RMB1,151 million in 2004. For Hong Kong regional flights, passenger traffic in RPKs increased by 68.0%, while passenger capacity in ASKs increased by 55.8%, resulting in a 4.5 percentage point increase in passenger load factor from 2003. Passenger yield decreased from RMB1.00 in 2003 to RMB0.88 in 2004 mainly due to intensified competition among airlines.

International passenger revenue, which accounted for 14.8% of total passenger revenue, increased by 51.7% from RMB2,978 million in 2003 to RMB4,519 million in 2004. For international flights, passenger traffic in RPKs increased by 52.8%, while passenger capacity in ASKs increased by 44.1%, resulting in a 3.6 percentage point rise in passenger load factor from 2003. Passenger yield remain steady in 2004 and at RMB0.55.

Cargo and mail revenue, which accounted for 8.4% of the Group s total traffic revenue and 8.2% of total operating revenue, increased by 13.5% from RMB2,459 million in 2003 to RMB2,792 million in 2004. The increase was attributable to the increasing traffic demand.

Other operating revenue increased by 58.7% from RMB586 million in 2003 to RMB930 million in 2004. The increase was primarily due to the general growth in income from various auxiliary operations.

Operating expenses

Substantially all of the Group s operating expenses result from its airline operations. The vast majority of such expenses relate directly to flight operations, aircraft and traffic servicing, aircraft repair and maintenance and to depreciation and amortisation in respect of aircraft and flight equipment. Expenses associated directly with the Group s flight operations (collectively, flight operations expenses) include fuel costs, operating lease payments, catering expenses, aircraft insurance, flight personnel payroll and welfare and training expenses. Expenses associated directly with repairs and maintenance in respect of the Group s aircraft (collectively, repairs and maintenance expenses) include repairs and maintenance and overhaul charges, the costs of consumables and other maintenance materials and labour costs for maintenance personnel. Expenses associated directly with the Group s aircraft and traffic servicing operations (collectively aircraft and traffic servicing expenses) include landing and navigation fees, rental payments and charges in respect of terminal and other ground facilities and labour costs for ground personnel. The balance of the Group s operating expenses result from promotional and marketing activities (collectively, promotional and marketing expenses) such as sales commissions, fees for use of the CAAC s reservation system, ticket-printing and sales office expenses, advertising and promotional expenses, and from general and administrative expenses, such as administrative salaries and welfare and other personnel benefits and office expenses, and from asset impairment charges.

Total operating expenses in 2004 amounted to RMB32,288 million, representing an increase of 28.6% or RMB7,171 million over 2003, primarily due to the combined effect of increases in jet fuel costs, maintenance expenses and aircraft and traffic servicing expenses. In addition, in 2003, the Group recorded an asset impairment charge of RMB510 million on certain aircraft of CNA. The Group did not incur any asset impairment charges on its aircraft in 2004. Total operating expenses as a percentage of total operating revenue decreased from 98.6% in 2003 to 94.5% in 2004.

Flight operations expenses, which accounted for 46.5% of total operating expenses, increased by 45.1% from RMB10,351 million in 2003 to RMB15,016 million in 2004, primarily as a result of increases in jet fuel costs, operating lease payments, catering expenses, labour costs for flight personnel and inclusion of CAAC Infrastructure Development Fund of RMB632 million in operating expenses which is an usage charge since 2004 but was a turnover-based levy and deducted against the traffic revenue in 2003. Jet fuel costs, which accounted for 57.0% of flight operations expenses, increased by 51.1% from RMB5,662 million in 2003 to RMB8,555 million in 2004 mainly as a result of increased fuel prices and fuel consumption. Operating lease payments increased by 16.6% from RMB1,808 million in 2003 to RMB2,109 million in 2004, primarily due to the additional rental payments for new aircraft under operating leases. Catering expenses increased by 30.9% from RMB754 million in 2003 to RMB987 million in 2004, primarily due to increase in number of passengers carried. Aircraft insurance costs decreased by 7.9% from RMB291 million in 2003 to RMB268 million in 2004, primarily because of a decrease in insurance premiums prescribed by the PRC insurance company. Labour costs for flight personnel increased by 37.2% from RMB1,126 million in 2003 to RMB1,545 million in 2004, largely due to the increase in flying hours.

Maintenance expenses which accounted for 14.2% of total operating expenses, increased by 18.1% from RMB3,878 million in 2003 to RMB4,578 million in 2004. The increase was primarily attributable to an 16.7% increase in aircraft overhaul charges from RMB2,913 million in 2003 to RMB3,399 million in 2004, which was resulted from fleet expansion in recent years.

Aircraft and traffic servicing expenses, which accounted for 14.8% of total operating expenses, increased by 25.9% from RMB3,803 million in 2003 to RMB4,789 million in 2004. The increase primarily resulted from an 25.7% rise in landing and navigation fees from RMB3,539 million in 2003 to RMB4,447 million in 2004, and an increase in number of landing and takeoffs.

Promotional and marketing expenses, which accounted for 8.1% of total operating expenses, increased by 27.6% from RMB2,043 million in 2003 to RMB2,606 million in 2004. The increase was due to 40.0% increase in labour costs from RMB305 million in 2003 to RMB427 million in 2004, as more payments of performance bonus were made because of the increased traffic volume.

General and administrative expenses, which accounted for 5.4% of the total operating expenses, increased by 25.9% from RMB1,397 million in 2003 to RMB1,759 million in 2004. This was mainly attributable to increased scale of operations.

Depreciation and amortisation, which accounted for 11.0% of total operating expenses, increased by 15.8% from RMB3,042 million in 2003 to RMB3,523 million in 2004. This increase was primarily as a result of the additions of aircraft during 2004.

Operating income

Operating income increased by 412.8% from RMB366 million in 2003 to RMB1,877 million in 2004. This was mainly because operating revenue increased by RMB8,682 million or 34.1% from 2003 and operating expenses increased by RMB7,171 million or 28.6% over the same period.

Non-operating income/(expenses)

Interest expense decreased by 26.2% from RMB1,604 million in 2003 to RMB1,184 million in 2004, mainly reflecting the combined effect of scheduled debt repayments and the replacement of certain RMB denominated bank loans of higher interest rates with US$ denominated bank loans of lower interest rates.

Interest income increased by 22.2% from RMB27 million in 2003 to RMB33 million in 2004. This was mainly attributable to an increase in average cash balances.

During 2004, the Group recorded a net exchange loss of RMB124 million (2003: RMB381 million) mainly from its Japanese yen denominated borrowings as a result of the Japanese yen appreciation. Such amount comprised mostly unrealised translational exchange loss.

Taxation

On 17 October, 2003, the Company s registered address was moved to Guangzhou Economic & Technology Development Zone, Guangzhou, China. In accordance with the Rules and Regulations for Implementation of Income Tax for Foreign Investment Enterprises and Foreign Enterprises of the PRC and a taxation approval document Guangzhou Municipal State Tax Bureau Suo De Shui Zi Que 020043 , the Company is entitled to enjoy the preferential tax policy implemented in the Guangzhou Economic & Technology Development Zone effective from 1 October, 2003. As a result, the Company s income tax rate has been changed from 33% to 15% beginning from that date. In 2003, the Group recorded an income tax benefit of RMB536 million resulting from a reduction in net deferred taxation liability balance of RMB341 million.

The airline operations of CNA and XJA were subject to PRC income tax at 33% during 2003 and up to December 30, 2004. As a result of the CNA/XJA Acquisitions having been effective December 31, 2004, the airline operations of CNA and XJA have become divisions of the Company and are subject to PRC income tax at the applicable rate of 15% beginning that date. Consequently, the airline operations of CNA and XJA recorded an income tax benefit of RMB99 million. Overall, net income tax expenses of the airline operations of CNA and XJA amounted to RMB274 million for 2004.

Minority interests

Minority interests increased by 52.0% from RMB127 million in 2003 to RMB193 million in 2004, primarily reflecting the increased net profits earned by certain of the Group s airline subsidiaries for the year.

Liquidity and Capital Resources

Prior to the initial public offering of the Company, the Group met its working capital and capital expenditure requirements through cash from its operations, the proceeds of certain long-term and short-term bank loans, capital lease financing and rebates available under certain of the Group s aircraft leases. In July 1997, the Company received net proceeds of RMB5,459 million from its initial public offering.

A majority part of these net proceeds was utilized to finance the Group s working capital and capital expenditure requirements. In July 2003, the Company issued 1,000,000,000 A Shares with a par value of RMB1.00 each at issue price of RMB2.70 by way of a public offering to natural persons and institutional investors in the PRC. The proceeds received by the Company, net of the issuance costs of RMB59,233, amounted to RMB2,641 million and have been used for the purchase of Boeing 737-800 aircraft in accordance with the disclosure in the Prospectus for Offering of the A Shares.

As of December 31, 2005, the Group had banking facilities with several PRC commercial banks for providing loan finance up to an approximate amount of RMB39,294 million to the Group. As of December 31, 2005, an approximate amount of RMB28,242 million was utilized. As of December 31, 2004 and 2005, the Group s cash and cash equivalents totaled RMB3,083 million and RMB2,901 million, respectively.

Net cash inflows from operating activities in 2003, 2004 and 2005 were RMB2,129 million, RMB3,596 million and RMB3,835 million, respectively.

Net cash used in investing activities in 2003, 2004 and 2005 was RMB5,434 million, RMB8,824 million and RMB8,009 million, respectively. Cash capital expenditures in 2003, 2004 and 2005 were RMB4,707 million, RMB6,631 million and RMB4,935 million, respectively, reflecting predominantly additional investments in aircraft and flight equipment under the Group s fleet expansion plans and Guangzhou new airport, and, to a small extent, additional investments in other facilities and buildings for operations.

Financing activities resulted in net cash inflows of RMB1,615 million, RMB6,231 million and RMB3,992 million in 2003, 2004 and 2005, respectively.

As of December 31, 2005, the Group s aggregate long-term debt and obligations under capital leases totaled RMB30,449 million. Based on such amount, in 2006, 2007, 2008, 2009, 2010 and thereafter, amounts payable under such debt and obligations will be RMB5,250 million, RMB7,246 million, RMB4,764 million, RMB2,812 million, RMB1,472 million and RMB8,905 million. Such borrowings were denominated, to a larger extent, in United States dollars and, to a smaller extent, in Japanese yen and Hong Kong dollars, with a significant portion being fixed interest rate borrowings. In the normal course of business, the Group is exposed to fluctuations in foreign currencies. The Group s exposure to foreign currencies was primarily as a result of its foreign currency debts. Depreciation or appreciation of the Renminbi against foreign currencies affects the Group s results significantly because the Group s foreign currency payments generally exceed its foreign currency receipts. The Group is not able to hedge its foreign currency exposure effectively other than by retaining its foreign currency denominated earnings and receipts to the extent permitted by the State Administration of Foreign Exchange, or subject to certain restrictive conditions, entering into forward foreign exchange contracts with authorised PRC banks.

As of December 31, 2005, the Group s short term bank debt was RMB14,346 million with interest rates ranging from 3.15% to 5.34% per annum. The Group s weighted average interest rate on short-term bank notes payable was 4.83% per annum as of December 31, 2005. The primary use of the proceeds of the Group s short-term debt is to finance working capital needs. The Group has generally been able to arrange short-term bank loans with domestic banks in China as necessary and believes it can continue to obtain them based on its well-established relationships with various lenders.

Through April 19, 2006, the Group renewed certain short-term bank debts of RMB2,611 million. The renewed debts are unsecured, bear interest at floating rates ranging from 3-month HIBOR/6-month LIBOR + 0.55% to 0.60% per annum and are repayable one year from their respective renewal dates. In addition, the Group entered into new short term bank debts agreement totalling RMB2,671 million subsequent to December 31, 2005. These new short term bank debts are unsecured and bear interest at floating rates ranging from 6-month LIBOR + 0.55% to 0.70% per annum with maturities through 2008.

From April 20, 2006 to May 31, 2006, the Group entered into additional new bank debts agreements totalling RMB3,808 million. These additional bank debts are unsecured, bear interest at floating rates ranging from 6-month LIBOR + 0.53% to 0.55% per annum and repayable one year from these respective origination dates.

As of December 31, 2005, the Group had obligations under operating leases totaling RMB24,594 million, predominately for aircraft. Of such amount, RMB3,340 million, RMB2,881 million, RMB2,785 million, RMB2,609 million, RMB2,523 million and RMB10,456 million, respectively, was due in 2006, 2007, 2008, 2009, 2010 and thereafter.

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As of December 31, 2005, the Group had a working capital deficit of RMB25,907 million, as compared to a working capital deficit of RMB18,855 million as of December 31, 2004. Historically, the Group operated in a negative working capital position, relying on cash inflow from operating activities and short-term bank debt refinancings to meet its short-term liquidity and working capital needs. The increase in the Group s working capital deficit from 2004 to 2005 was mainly because the Group sought increased short term debts to finance its aircraft acquisitions. Upon deliveries of the aircraft, the Group continued to seek renewal of its short-term debts instead of replacing such debts with long-term debts, as the interest rates for short-term debts are lower. The liquidity of the Group in the future will primarily be dependent on its ability to maintain adequate cash inflow from operations to meet its debt obligations as they become due and, on its ability to obtain adequate external financing to meet its committed future capital expenditures. The Group has obtained firm commitments from its principal bankers to renew its short-term bank loans outstanding at December 31, 2005 when they fall due during 2006. Subsequent to December 31, 2005, the Group renewed short-term debts of RMB2,611 million.

As the Group is subject to a high degree of operating leverage, a minor decrease in the Group s yield and/or load factor could result in a significant decrease in its operating revenue and hence its operating cashflows. This could arise in such circumstances as where competition between Chinese airlines increases or where PRC aviation demand decreases. Similarly, a minor increase in the jet fuel prices, particularly those in domestic market, could result in a significant increase in the Group s operating expenses and hence a significant decrease in its operating cashflows. This could be caused by fluctuations in supply and demand in international oil market. Currently, the Group s existing debt and lease facilities do not contain any financial covenants. Nevertheless, as the Group is subject to a high degree of financial leverage, an adverse change in the Group s operating cashflows could adversely affect its financial health and hence weaken its ability to obtain additional debt and lease facilities and to renew its short-term debt facilities as they fall due.

As of December 31, 2005, the Group had capital commitments in 2006, 2007, 2008, 2009 and 2010 of approximately RMB8,933 million, RMB9,445 million, RMB14,437 million, RMB5,300 and RMB9,688 respectively. Of such amounts, RMB7,341 million in 2006, RMB8,945 million in 2007 and RMB14,354 million in 2008, RMB5,300 million in 2009 and RMB9,688 million in 2010 are related to the acquisition of aircraft and related flight equipment, and RMB840 million in 2006 is related to the Group s facilities and equipment to be constructed and installed at the Guangzhou new airport. The remaining amounts of RMB752 million in 2006, RMB500 million in 2007 and RMB83 million in 2008 are related to the Group s other airport and office facilities and equipment, overhaul and maintenance bases and training facilities.

As of December 31, 2005, the Group undertook to make a capital contribution of approximately RMB83 million to jointly controlled entities.

As of December 31, 2005, the cash and cash equivalents of the Group totaled RMB2,901 million. Of such balance, 20.4% was denominated in foreign currencies.

No interim dividend was paid during the year ended December 31, 2005. The Board of Directors does not recommend the payment of a final dividend in respect of the year ended December 31, 2005.

The Group expects that the Group s cash from operations and short-term and long-term bank borrowings will be sufficient to meet its cash requirements in the foreseeable future.

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Contractual Obligations and Commercial Commitments

The following table sets forth the Group s obligations and commitments to make future payments under contracts and under contingent commitments as of December 31, 2005.

	As of December 31, 2005 Payment due by period					As of December 31, 2004
	Total	less than 1 year	1-3 years	4-5 years	After 5 years	Total
	(RMB million)					
Contractual obligations						
Short-term debt (Note 2)	**14,346**	11,735	2,611			9,925
Long-term debt	**14,617**	1,877	6,472	2,095	4,173	13,528
Capital lease obligations	**15,832**	3,373	5,538	2,189	4,732	11,743
Cash payable for CNA/ XJA Acquisitions						1,959
Total contractual obligations	**44,795**	**16,985**	**14,621**	**4,284**	**8,905**	**37,155**
Other commercial commitments						
Operating lease commitments	**24,594**	3,340	5,666	5,132	10,456	12,750
Aircraft purchase commitments (Note 1)	**45,628**	7,341	23,299	14,988		11,776
Capital commitments in respect of investments in the Guangzhou new airport	**840**	840				824
Other capital commitments	**1,335**	752	583			700
Investing commitments	**83**	83				83
Total commercial obligations	**72,480**	**12,356**	**29,548**	**20,120**	**10,456**	**26,133**