



REPORT OF THE DIRECTORS

The Board of Directors of the Company hereby presents this report and the audited consolidated financial statements of the Group for the year ended 31 December, 2003.

PRINCIPAL ACTIVITIES, OPERATING RESULTS AND FINANCIAL POSITION

The Group is principally engaged in airline operations. The Group also operates certain airline related businesses, including aircraft maintenance and air catering operations. The Group is one of the largest airlines in China. In 2003, the Group ranked first among all Chinese airlines in terms of passenger traffic volume, number of scheduled flights per week, number of hours flown, number of routes and size of aircraft fleet. The Group has prepared the results of operations for the year ended 31 December, 2003, and the financial position of the Company and the Group as of that date in accordance with IFRS and PRC Accounting Rules and Regulations. See pages 39 to 182 of this Annual Report.

FIVE-YEAR SUMMARY

A summary of the results and the assets and liabilities of the Group prepared under IFRS for the five-year period ended 31 December, 2003 are set out on pages 189 and 190 of this Annual Report.

DIVIDENDS

No interim dividend was paid during the year ended 31 December, 2003 (2002: Nil).

The Board of Directors of the Company does not recommend the payment of a final dividend in respect of the year ended 31 December, 2003 (2002: Nil).

BANK LOANS AND OTHER BORROWINGS

Details of the bank loans and other borrowings of the Company and the Group are set out in notes 21 and 22 to the consolidated financial statements prepared under IFRS.

INTEREST CAPITALIZATION

For the year ended 31 December, 2003, RMB83,077,000 interest (2002: RMB64,186,000) was capitalised as the cost of construction in progress and fixed assets.

FIXED ASSETS

Fixed assets of the Company and the Group and movements of fixed assets during the year ended 31 December, 2003 are set out in note 10 to the consolidated financial statements prepared under IFRS.



REPORT OF THE DIRECTORS (Cont'd)

MAJOR CUSTOMERS AND SUPPLIERS

The percentage of turnover attributable to the Group's five largest customers in aggregate was less than 30% of the Group's total operating revenue (i.e. turnover) for the year ended 31 December, 2003.

The percentage of purchases attributable to the largest supplier and the five largest suppliers in aggregate represented approximately 60% and 72%, respectively, of the Group's total purchases (not including purchases of items which are of a capital nature) for the year ended 31 December, 2003.

At no time during the year ended 31 December, 2003 have any Directors, associates of Directors or shareholders of the Company owning, to the knowledge of the Directors, more than 5% of the Company's share capital and any interest in the Group's five largest customers or suppliers.

TAXATION

Details of taxation of the Company and the Group are set out in note 7 to the consolidated financial statements prepared under IFRS.

RESERVES

Movements in the reserves of the Company and the Group during the year are set out in note 26 to the consolidated financial statements prepared under IFRS.

EMPLOYEES AND EMPLOYEES' PENSION SCHEME

As at 31 December, 2003, the Group had an aggregate of 17,569 employees (2002: 17,031). Details of the employees' pension schemes and other welfare are set out in note 28 to the consolidated financial statements prepared under IFRS.

SUBSIDIARIES

Details of the principal subsidiaries of the Company are set out in note 36 to the consolidated financial statements prepared under IFRS.

**REPORT OF THE DIRECTORS (Cont'd)****SHARE CAPITAL STRUCTURE**

With the approval of the China Securities Regulatory Commission, the Company issued 1,000,000,000 A Shares of RMB1 each to public at an issue price of RMB2.7 each from 10 July to 17 July, 2003 and successfully raised gross share proceeds of RMB2.7 billion. The A Shares issued are listed on the Shanghai Stock Exchange since 25 July, 2003 (Abbreviation: Southern Airlines; stock code: 600029).

Owing to the issuance of A Shares, the Company's total share capital has increased from 3,374,178,000 shares to 4,374,178,000 shares. The share capital of the Company is set out below:

Type of shares	Before issuance of A Shares		After issuance of A Shares	
	Number of shares	Approximate percentage of total share capital (%)	Number of shares	Approximate percentage of total share capital (%)
1. Unlisted shares				
State-owned shares	2,200,000,000	65.2	2,200,000,000	50.30
2. Listed shares				
1. Overseas listed foreign shares (H Shares)	1,174,178,000	34.8	1,174,178,000	26.84
2. Domestic listed ordinary shares (A Shares)	-	-	1,000,000,000	22.86
Total share capital	3,374,178,000	100	4,374,178,000	100



REPORT OF THE DIRECTORS (Cont'd)

SUBSTANTIAL SHAREHOLDERS

As at 31 December, 2003, to the knowledge of the Directors, chief executive and Supervisors of the Company, the interests and short positions of the following persons other than the Directors, chief executives or Supervisors in the shares and underlying shares of the Company as recorded in the register of the Company required to be kept under section 336 of the Securities and Futures Ordinance (the "SFO") or otherwise persons who have an interest of 10% or more in the Company's shares are as follows:

Name of shareholder	Type of shareholding	Type of share	Number of share held	% of the total issued H Shares of the Company	% of the total issued share capital of the Company	% of the total issued domestic shares of the Company	Short position
CSAHC	Direct holding	State-owned Shares	2,200,000,000	-	50.30%	68.75%	-
HKSCC Nominees Limited	Direct holding	H Shares	1,149,955,998	97.94%	26.29%	-	-

Note:

Based on the information available to the Directors, chief executive and Supervisors of the Company (including such information as was available on the website of the Hong Kong Stock Exchange) and so far as the Directors, chief executive and Supervisors are aware, as at 31 December, 2003:

1. Among the 1,149,955,998 H Shares held by HKSCC Nominees Limited, Li Ka-Shing Unity Trustcorp Limited had an interest in an aggregate of 193,877,000 H Shares of the Company (representing approximately 16.51% of its then total issued H Shares) in the capacity as beneficiary of a trust.
2. Among the 1,149,955,998 H Shares held by HKSCC Nominees Limited, J.P. Morgan Chase & Co. had an interest in an aggregate of 139,239,800 H Shares of the Company (representing approximately 11.86% of its then total issued H Shares). Out of the 139,239,800 H Shares, J.P. Morgan Chase & Co. had an interest in a lending pool comprising 19,849,000 H Shares of the Company (representing approximately 1.69% of its then total issued H Shares). According to the information as disclosed in the website of the Hong Kong Stock Exchange and so far as the Directors, chief executive and Supervisors are aware, J.P. Morgan Chase & Co. held its interest in the Company in the following manners:
 - (a) 19,849,000 H Shares in a lending pool, representing approximately 1.69% of the Company's then total issued H Shares, were held by J.P. Morgan Chase Bank, which was 100% held by J.P. Morgan Chase & Co.;
 - (b) 3,856,800 H Shares, representing approximately 0.33% of the Company's then total issued H Shares, were held in the capacity as beneficial owner by J.P. Morgan Whitefriars Inc., which was ultimately 100% held by J.P. Morgan Chase & Co.;
 - (c) 115,138,000 H Shares, representing approximately 9.81% of the Company's then total issued H Shares, were held in the capacity as investment manager by JF Asset Management Limited, which was approximately 99.99% held by J.P. Morgan Fleming Asset Management (Asia) Inc., which was ultimately 100% held by J.P. Morgan Chase & Co.; and
 - (d) 396,000 H Shares, representing approximately 0.03% of the Company's then total issued H Shares, were held in the capacity as beneficial owner by J.P. Morgan Securities Ltd., which was approximately 90% held by J.P. Morgan Holdings (UK) Limited, which was ultimately 100% held by J.P. Morgan Chase & Co..

**REPORT OF THE DIRECTORS (Cont'd)**

3. Among the 1,149,955,998 H Shares held by HKSCC Nominees Limited, Morgan Stanley International Incorporated had an interest in an aggregate of 111,121,932 H Shares of the Company (representing approximately 9.46% of its then total issued H Shares). According to the information as disclosed on the website of the Hong Kong Stock Exchange and so far as the Directors, chief executive and Supervisors are aware, Morgan Stanley International Incorporated which was (or its directors were) accustomed to act in accordance with the directors of Morgan Stanley, held its indirect interest in the Company as at 31 December, 2003 in the manner as follows:
- (a) 743,322 H Shares, representing approximately 0.06% of the Company's then total issued H Shares, were held by Morgan Stanley Dean Witter Hong Kong Securities Limited, which was ultimately 100% held by Morgan Stanley Asia Pacific (Holdings) Limited, which, in turn, was 90% held by Morgan Stanley International Incorporated;
 - (b) 108,670,000 H Shares, representing approximately 9.25% of the Company's then total issued H Shares, were held by Morgan Stanley Investment Management Company, which was ultimately 100% held by Morgan Stanley Asia Pacific (Holdings) Limited, which, in turn, was 90% held by Morgan Stanley International Incorporated;
 - (c) 292,600 H Shares, representing approximately 0.02% of the Company's then total issued H Shares, were held by Morgan Stanley Asset & Investment Trust Management Co. Limited, which was 100% held by Morgan Stanley International Incorporated;
 - (d) 714,000 H Shares, representing approximately 0.06% of the Company's then total issue H Shares, were held by Morgan Stanley & Co International Limited, which was ultimately 100% held by Morgan Stanley Group (Europe), which, in turn, was approximately 98.30% held by Morgan Stanley International Limited, in which Morgan Stanley International Incorporated held 100% control; and
 - (e) 702,000 H Shares, representing approximately 0.06% of the Company's then total issued H Shares, were held by Morgan Stanley Capital (Luxembourg) S.A., which was approximately 93.75% held by Morgan Stanley International Incorporated.

According to the information as disclosed on the website of the Hong Kong Stock Exchange and so far as the Directors, chief executive and Supervisors are aware, as at 31 December, 2003, Morgan Stanley Dean Witter Hong Kong Securities Limited also had a short position in 616,000 H Shares of the Company (representing approximately 0.05% of its then total issued H Shares).

4. Among the 1,149,955,998 H Shares held by HKSCC Nominees Limited, 96,938,500 H Shares, representing approximately 8.26% of the Company's then total issued H Shares, were held by Space Dragon Limited as beneficial owner, which was 100% held by Cheung Kong Investment Company Limited.
5. Among the 1,149,955,998 H Shares held by HKSCC Nominees Limited, 96,938,500 H Shares, representing approximately 8.26% of the Company's then total issued H Shares, were held by Choicewell Limited as beneficial owner, which was ultimately 100% held by Hutchison Whampoa Limited.

Save as disclosed above, as at 31 December 2003, to the knowledge of the Directors, chief executive and Supervisors of the Company, no other person (other than the Directors, chief executives or Supervisors) had an interest or short positions in the shares or underlying shares of the Company as recorded in the register of the Company required to be kept under section 336 of the SFO or otherwise had an interest of 10% or more in the Company's shares.



REPORT OF THE DIRECTORS (Cont'd)

PARTICULARS OF SHAREHOLDERS

The total number of shareholders of the Company as at 31 December, 2003 was 152,747, of which 150,147 were shareholders of A Shares and 2,600 were shareholders of H Shares.

Particulars of shareholdings of the Company's ten largest shareholders as at the end of the reporting period are as follows:

Shareholdings of ten largest shareholders

No.	Name of shareholders	Increase/decrease during the year	Shareholdings at the end of the year	Percentage (%)	Type of shares	Number of pledged or frozen shares	Nature of shares held
1.	CSAHC	–	2,200,000,000	50.30	Unlisted	–	State-owned shares
2.	HKSCC NOMINEES LIMITED	314,000	1,149,955,998	26.29	Listed	Unknown	H Shares
3.	Huaxia Growth	59,000,000	59,000,000	1.35	Listed	Unknown	A Shares
4.	Huaxia Return	56,865,741	56,865,741	1.30	Listed	Unknown	A Shares
5.	Xinghua Fund	30,160,190	30,160,190	0.69	Listed	Unknown	A Shares
6.	Yinfeng Fund	25,697,368	25,697,368	0.59	Listed	Unknown	A Shares
7.	Xinghe Fund	24,536,588	24,536,588	0.56	Listed	Unknown	A Shares
8.	Anxin Fund	21,001,852	21,001,852	0.48	Listed	Unknown	A Shares
9.	Fenghe Value	20,940,086	20,940,086	0.48	Listed	Unknown	A Shares
10.	Yuyuan Fund	15,007,147	15,007,147	0.34	Listed	Unknown	A Shares

PURCHASE, SALE OR REDEMPTION OF SHARES

Neither the Company nor any of its subsidiaries purchased, sold or redeemed any shares of the Company during 2003.

USE OF PROCEEDS FROM H SHARE OFFERING AND A SHARE OFFERING

As stated in the 2002 Annual Report of the Company, as of 31 December, 2002, the Company had RMB40 million remaining from the proceeds of the initial public offering of the H Shares of the Company. As at 31 December, 2003, the RMB40 million has been used for the development of the Company's computerised accounting system and flights controlling system in accordance with the disclosure in the Prospectus of the Company dated July 1997.

The proceeds from the issue of A Shares have been used for the purchases of Boeing 737-800 aircraft in accordance with the disclosure in the Prospectus for Offering of the A Shares. There has been no change in the use of proceeds.

**REPORT OF THE DIRECTORS (Cont'd)****PRE-EMPTIVE RIGHTS**

Neither the Articles of Association of the Company nor the laws of the PRC provide for any pre-emptive rights requiring the Company to offer new shares to existing shareholders in proportion to their existing shareholdings.

COMPLIANCE WITH THE CODE OF BEST PRACTICE

In the opinion of the Directors of the Company, the Group has complied with the Code of Best Practice set out in Appendix 14 of the Listing Rules issued by The Stock Exchange of Hong Kong Limited ("the Hong Kong Stock Exchange") throughout the year ended 31 December, 2003.

DIRECTORS, SUPERVISORS AND SENIOR ADMINISTRATIVE OFFICERS

Directors, Supervisors and Senior Administrative Officers of the Company in 2003 were as follows:

Name	Age	Position	Number of shares of the Company held	Capacity in which the shares were held
Yan Zhi Qing	62	Chairman of the Board of Directors	0	–
Liu Ming Qi	60	Vice Chairman of the Board of Directors	0	–
Wang Chang Shun	47	Vice Chairman of the Board of Directors, President	0	–
Peng An Fa	56	Director	0	–
Wang Quan Hua	50	Director	0	–
Zhao Liu An	56	Director	0	–
Zhou Yong Qian	59	Director	0	–
Zhou Yong Jin	61	Director	0	–
Xu Jie Bo	39	Director, Chief Financial Officer, Vice President	0	–
Wu Rong Nan	62	Director	0	–
Simon To	53	Independent Non-Executive Director	100,000 H Shares	Interest of spouse
Peter Lok	68	Independent Non-Executive Director	0	–
Wei Ming Hai	40	Independent Non-Executive Director	0	–
Wang Zhi	62	Independent Non-executive Director	0	–
Sui Guang Jun	43	Independent Non-executive Director	0	–
Liang Hua Fu	62	Chairman of the Supervisory Committee	0	–
Gan Yu Hua	76	Supervisor	0	–
Li Qi Hong	56	Supervisor	0	–
Jiang Ping	54	Vice President	0	–
Li Kun	44	Vice President	0	–
Yuan Xin An	47	Vice President	1,000 A Shares	Beneficial owner
Zheng En Ren	59	Vice President	0	–
Hao Jian Hua	54	Vice President	0	–
Su Liang	42	Company Secretary	0	–



REPORT OF THE DIRECTORS (Cont'd)

On 13 May, 2003, Mr. Liu Ming Qi, Mr. Peng An Fa, Mr. Wang Quan Hua, Mr. Zhao Liu An, Mr. Zhou Yong Qian, Mr. Wang Zhi and Mr. Sui Guang Jun respectively were appointed as Directors of the Company at the Shareholders' meeting of the Company.

On 13 May, 2003, Mr. Wang Shao Xi and Mr. Zhang Rui Ai tendered their resignations to the Company as Directors of the Company due to retirement. Their resignations were approved at the Shareholders' meeting of the Company.

On 30 July, 2003, the Board of Directors resolved to appoint Mr. Hao Jian Hua and Mr. Xu Jie Bo as Vice Presidents of the Company. On the same day, Mr. Yang Guang Hua resigned as Vice President of the Company due to work arrangement.

Biographical details of the Board of Directors, Senior Administrative Officers and members of the Supervisory Committee are set out on pages 191 to 195 of this Annual Report.

INTERESTS AND SHORT POSITIONS OF DIRECTORS AND SUPERVISORS IN THE COMPANY AND ASSOCIATED CORPORATIONS

As at 31 December, 2003, the interests and short positions of the Directors and Supervisors of the Company in the shares, underlying shares and debentures (as the case may be) of the Company or its associated corporations (within the meaning of Part XV of the SFO) which were notified to the Company and the Hong Kong Stock Exchange pursuant to SFO (including interests or short positions which are taken or deemed to have under such provisions of the SFO), or recorded in the register maintained by the Company pursuant to section 352 of the SFO or which were notified to the Company and the Hong Kong Stock Exchange pursuant to the "Model Code for Securities Transactions by Directors of the Listed Companies" in schedule 10 of the Listing Rules are as follows:

Name	The Company/ associated corporation	Types of interest	Type of shares	Number of shares held	% to the total issued share capital of the Company	% to the total issued domestic shares of the Company	% to the total issued H shares of the Company	Short position
Simon To	the Company	Interest of spouse (Note 1)	H Shares	100,000	0.002%	–	0.009%	–

Note 1: The spouse of Mr. Simon To is the owner of these 100,000 H Shares of the Company and accordingly, Mr. Simon To, is taken to be interested in these 100,000 H Shares by virtue of the SFO.

Save as disclosed above, as at 31 December, 2003, none of the Directors or Supervisors of the Company has interests or short positions in the shares, underlying shares and/or debentures (as the case may be) of the Company or its associated corporations (within the meaning of Part XV of the SFO) which were notified to the Company and the Hong Kong Stock Exchange pursuant to SFO (including interests or short positions which are taken or deemed to have under such provisions of the SFO), or recorded in the register maintained by the Company pursuant to section 352 of the SFO or which were notified to the Company and the Hong Kong Stock Exchange pursuant to the "Model Code for Securities Transactions by Directors of the Listed Companies" in schedule 10 of the Listing Rules.



REPORT OF THE DIRECTORS (Cont'd)

SERVICE CONTRACTS OF THE DIRECTORS AND SUPERVISORS

All Directors and Supervisors of the Company have entered into service contracts with the Company for a term of three years commencing on 16 April, 2001. The service contracts of Liu Ming Qi, Peng An Fa, Wang Quan Hua, Zhao Liu An, Zhou Yong Qian, Wang Zhi and Sui Guang Jun entered into on 13 May, 2003 will expire at the end of the term of the current session of the Board. Except for such service contracts, none of the Directors or Supervisors of the Company has entered or proposed to enter into any other service contracts with the Company or its subsidiaries. None of the Directors or Supervisors has entered into any service contracts with the Company which is not determinable by the Company within one year without payment of compensation, other than statutory compensation.

INTERESTS OF DIRECTORS AND SUPERVISORS IN CONTRACTS

In 2003, none of the Directors and Supervisors of the Company had a material interest in any contract of significance to which the Company or any of its subsidiaries was a party.

CONNECTED TRANSACTIONS

The Company enters from time to time into certain connected transactions with CSAHC and other connected persons. Such transactions fall within the definition of connected transactions as set out in Chapter 14 of the Listing Rules issued by the Stock Exchange of Hong Kong Limited ("the Hong Kong Stock Exchange"). The Hong Kong Stock Exchange has granted waivers to the Company in respect of compliance with certain provisions of Chapter 14 of the Listing Rules. Details of such transactions conducted during the year and/or the related agreements entered into between the Company and such parties for which waivers have been obtained are disclosed as follows:

(A) De-merger Agreement

The De-merger Agreement dated 25 March, 1995 (such Agreement was amended by Amendment No.1 dated 22 May, 1997) was entered into between the CSAHC and the Company for the purpose of defining and allocating the assets and liabilities between CSAHC and the Company. Under the De-merger Agreement, CSAHC and the Company have agreed to indemnify the other party against claims, liabilities and expenses incurred by such other party but relating to the businesses, assets and liabilities held or assumed by CSAHC or the Company (as the case may be) pursuant to the De-merger Agreement.

Neither the Company nor CSAHC has made any payments in respect of such indemnification obligations from the date of the De-merger Agreement up to the date of this report.



REPORT OF THE DIRECTORS (Cont'd)

(B) Connected Business Transactions

The Company and CSAHC and their respective subsidiaries were a single group prior to the restructuring of CSAHC in 1995 in anticipation of the Company's global offering ("Restructuring"). As a result, certain arrangements between them have continued after the Restructuring and the listing of the Company's shares on the Hong Kong Stock Exchange and New York Stock Exchange. At present, the Company and CSAHC (or their respective subsidiaries) have entered into the following agreements:

- (a) *Southern Airlines (Group) Import and Export Trading Company ("SAIETC"), a wholly-owned subsidiary of CSAHC*

The Company and Southern Airlines have entered into an agreement dated 22 May, 1997 for the import and export of aircraft, flight equipment, special vehicles for airline use, communication and navigation facilities, and training facilities for a term from 22 May, 1997 to 22 May, 2000 which was subsequently extended to 2006 by mutual agreement between the parties. The parties have mutually agreed that the agreement can be extended automatically.

For the year ended 31 December, 2003, the amount incurred by the Group for the import and export of the above equipment was RMB1,154,553,000 inclusive of agency commission of 1.5% above the contract prices paid to SAIETC.

- (b) *Southern Airlines Advertising Company, which is 90% owned by the Company and 10% owned by CSAHC ("CSAHC")*

On 26 August, 2002, the Company had entered into a takeover agreement with CSAHC. As a result, the Company owns 90% and CSAHC owns 10% of Southern Airlines Advertising Company.

The Company and Southern Airlines Advertising Company have entered into an agreement dated 22 May, 1997 for the provision of advertising services for a term extending from 22 May, 1997 to 22 May, 2000. After extension of three years, the parties have mutually agreed to extend the agreement for another three years to 22 May, 2006.

For the year ended 31 December, 2003, the amount incurred by the Group to Southern Airlines Advertising Company for advertising services was RMB1,320,000.

**REPORT OF THE DIRECTORS (Cont'd)**

- (c) *Southern Airlines Group Finance Company Limited ("SA Finance") which is 42% owned by CSAHC, 32% owned by the Company, 26% owned in aggregate by five subsidiaries of the Company*

The Company has entered into a financial agreement 22 May, 1997 with SA Finance for the provision of financial services such as deposit and loan facilities, credit facilities, financial guarantees and credit references for a term commencing from 22 May, 1997 to 22 May, 2000. As agreed by the parties, the agreement has been extended for six years to 22 May, 2006.

Under such agreement, (a) all funds that the Company deposits with SA Finance will be deposited by SA Finance with the Industrial and Commercial Bank of China, Bank of Communications, Bank of Agriculture, China Construction Bank, or other banks of similar creditworthiness; and (b) SA Finance will not at any time have outstanding loans in excess of the amount representing the aggregate of (i) deposits received from entities other than the Company, (ii) SA Finance's shareholders' equity and (iii) capital reserves.

The Group had short-term deposits placed with SA Finance at 31 December, 2003 amounting to RMB365,906,000 which earned interest at the rate of 1.98%–3.00% per annum.

- (d) *Shenzhen Air Catering Company Limited, which is 33% owned by CSAHC, and 67% owned by two independent third parties*

The Company and Shenzhen Air Catering Company Limited have entered into an agreement dated 23 May, 1997 for the sale and purchase of in-flight meals for flights originating or stopping at the airport in Shenzhen. Pursuant to such agreement, Shenzhen Air Catering Company Limited will supply in-flight meals to the Group from time to time during the term from 23 May, 1997 to 23 May, 1998. The parties have mutually agreed that the agreement can be extended automatically.

For the year ended 31 December, 2003, the amount incurred by the Group to Shenzhen Air Catering Company Limited for the provision of in-flight meals was approximately RMB28,199,000.

- (e) *Guangzhou Aircraft Maintenance Engineering Company Limited ("GAMECO"), which is 50% owned by the Company and 50% owned by an independent third party*

The Company and GAMECO have entered into an Aircraft Maintenance and Engineering Agreement for the provision of aircraft repair and maintenance services. On 17 May, 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 15%, and labor costs at US\$30.0 per hour during 2003.

For the year ended 31 December, 2003, the amount incurred by the Group for such repair and maintenance services was RMB587,252,000.



REPORT OF THE DIRECTORS (Cont'd)

- (f) *China Southern West Australian Flying College Pty Ltd (the "Australian Pilot College"), which is 65% owned by the Company and 35% owned by CSAHC*

CSAHC and the Australian Pilot College entered into an agreement dated 7 October, 1993 for the provision of pilot training in Australia to the cadet pilots of CSAHC (the "Training Agreement"). The Training Agreement will remain in force unless terminated by either party upon 90 days' prior written notice to the other party. Pursuant to the De-merger Agreement, the Company has assumed all the interests, rights and obligations of CSAHC under the Training Agreement.

For the year ended 31 December, 2003, the amount paid by the Group to the Australian Pilot College for training services was RMB82,386,000.

- (g) *Southern Airlines (Group) Economic Development Company, which is 61% owned by CSAHC and 39% owned by an independent third party*

The Company and Southern Airlines (Group) Economic Development Company have entered into an agreement dated 22 May, 1997 for the provision of drinks, snacks, liquor, souvenirs and other products for a term extending from 22 May, 1997 to 22 May, 2007.

For the year ended 31 December, 2003, the amount paid by the Group to Southern Airlines (Group) Economic Development Company for the provision of drinks, snacks, liquor, souvenirs and other products was RMB42,849,000.

- (h) *Guangzhou Nanland Air Catering Company Limited ("Nanland"), which is 51% owned by the Company and 49% owned by an independent third party*

The Company and Nanland have entered into a catering agreement dated 22 May, 1999 for the sale and purchase of in-flight meals for flights originating or stopping at the airport in Guangzhou. Pursuant to such agreement, Nanland will supply in-flight meals to the Company from time to time during the term from 22 May, 1999 to 22 May, 2000. The agreement will then be automatically extended annually.

For the year ended 31 December, 2003, the amount paid by the Group to Nanland for the provision of in-flight meals was RMB70,194,000.

- (i) *Ticket sales arrangements*

The Group has entered into ticket agency agreements for the sale of the Group's air tickets with several subsidiaries of CSAHC (the "Agents"). The Agents charge commission on the basis of the rates stipulated by the CAAC and International Air Transport Association ("IATA"). The Agents charge a commission in the amount of 3% of the ticket price for domestic tickets and 5% to 12% of the ticket price for Hong Kong regional/ international tickets. The Group has other air ticket sales agents in China who also charge commission at the same rates. The Agents also act as air ticket sales agents for other Chinese airlines and charge the same rates of commission to such other airlines as those charged to the Group.

For the year ended 31 December, 2003, the aggregate amount of ticket sales of the Group conducted through the Agents was RMB143,016,000.

**REPORT OF THE DIRECTORS (Cont'd)****(C) Trademark Licence Agreement**

The Company and CSAHC have entered into a 10 year Trademark Licence Agreement dated 22 May, 1997 pursuant to which CSAHC acknowledges that the Company has the right to use the name "China Southern" and "China Southern Airlines" in both Chinese and English, and grants to the Company a renewable royalty free licence to use the kapok logo on a worldwide basis in connection with the Company's airline and airline-related businesses. Unless CSAHC gives written notice of termination three months before the expiration of the agreement, the agreement will be automatically extended for another 10-year term.

(D) Leases

CSAHC

The Company as lessee and CSAHC as lessor have entered into the following lease agreements:

- (a) The Company and CSAHC have entered into a land lease agreement dated 22 May, 1997, in respect of the land used by the Company within Guangzhou Baiyun International Airport. The rental payment is RMB2,650,700 per year. The term of the lease is five years commencing 1 April, 1997 and is renewable by the parties thereafter (subject to mutual agreement with respect to rental terms).
- (b) The Company and CSAHC have separately entered into four lease agreements dated 22 May, 1997, in respect of office premises located at the east wing of the Guangzhou Railway Station on Guangzhou Huanshi Dong Road, office premises at Haikou Airport, office premises in Haikou City, and office premises at Tianhe Airport in Wuhan, Hubei Province. The aggregate rental payment under the four leases is RMB12,573,000 per year. The term of each lease is one year and is renewable by the parties thereafter (subject to mutual agreement with respect to rental terms).
- (c) The Company and CSAHC have entered into an indemnification agreement dated 22 May, 1997 in which CSAHC has agreed to indemnify the Company against any loss or damage caused by or arising from any challenge of, or interference with, the Company's right to use certain land and buildings.

Xinjiang Airlines Company ("Xinjiang Airlines"), a wholly owned subsidiary of CSAHC

The Company and Xinjiang Airlines have entered into an aircraft lease agreement dated 8 April, 2002, whereby Xinjiang Airlines wet leased a Boeing 757-200 aircraft, together with aircrew and other parts and equipment for the operation of the aircraft, including engine and such spare parts necessary for its maintenance during the term of the lease. The rental payment payable by the Company under the lease for year 2003 was RMB35,751,000.



REPORT OF THE DIRECTORS (Cont'd)

(E) Comprehensive Services and Employee Benefits

The Company and CSAHC have entered into a comprehensive services agreement (the "Services Agreement") dated 22 May, 1997.

The Services Agreement provides that CSAHC shall sell or rent housing to eligible employees of the Group at lower than market price. As the housing is sold or rented below cost and the construction costs of the leased housing were originally paid by CSAHC, the Company shall pay CSAHC RMB85 million per year, payable quarterly in arrears, for a term of ten years from 1995 to 2004.

(F) Ongoing Connected Transactions with China Northern Airlines Company and Xinjiang Airlines

China Northern Airlines Company ("Northern Airlines"), a wholly owned subsidiary of CSAHC

Northern Airlines is principally engaged in commercial airline services in the PRC with its headquarters based in Shenyang, East Northern part of the PRC. Following the consolidation and restructuring among CSAHC, Northern Airlines and Xinjiang Airlines in 2002 (the "Consolidation and Restructuring"), Northern Airlines becomes a wholly owned subsidiary of CSAHC and therefore constitutes a connected person of the Company under the Listing Rules.

Xinjiang Airlines

Xinjiang Airlines is principally engaged in commercial airline services in the PRC with its headquarters based in Urumqi, Xinjiang. Following the Consolidation and Restructuring, Xinjiang Airlines becomes a wholly owned subsidiary of CSAHC and therefore constitutes a connected person of the Company under the Listing Rules.

(a) In-flight Meals Arrangement with Northern Airlines

Nanland has been providing and will provide in-flight meals to Northern Airlines. Pursuant to an agreement dated 23 June, 2000, Nanland has been providing in-flight meals to Northern Airlines from time to time for a period of one year. The agreement will then be automatically extended annually. For the year ended 31 December, 2003, the amount paid by Northern Airlines to Nanland for the provision of in-flight meals was approximately RMB4,657,000.

Pursuant to an agreement dated 30 October, 2001, Northern Airlines has been providing and will provide in-flight meals to the Group from time to time for a period of one year. The agreement will then be automatically extended annually.

For the year ended 31 December, 2003, the amount paid by the Group to Northern Airlines for the provision of in-flight meals was approximately RMB2,321,000.

**REPORT OF THE DIRECTORS (Cont'd)****(b) In-flight Meals Arrangement with Xinjiang Airlines**

Pursuant to an agreement dated 24 March, 2001, Nanland has been providing and will provide in-flight meals to Xinjiang Airlines from time to time for a period of one year. The agreement will then be automatically extended annually. For the year ended 31 December, 2003, the amount paid by Xinjiang Airlines to Nanland for the provision of in-flight meals was approximately RMB1,806,000.

Pursuant to an agreement dated 20 September, 1999, Xinjiang Airlines has been providing and will provide in-flight meals to the Group for a period of one year. The agreement will then be automatically extended annually. The amount paid by the Group to Xinjiang Airlines for the provision of in-flight meals for the year ended 31 December, 2003 was approximately RMB2,888,000.

(c) Ticket Sales Arrangement with Northern Airlines

In accordance with the relevant requirement and industry practice, the Group has entered into ticket agency arrangement with Northern Airlines for the sale of the Group's air tickets by Northern Airlines and for the sale of Northern Airlines air tickets by the Group. The selling party charges a commission in the amount of 3% of the ticket price for domestic tickets and 5% to 12% of the ticket price for Hong Kong regional and international tickets. These commission rates are based on the rates stipulated by the CAAC and IATA. The amount of commission paid by Northern Airlines to the Group for the year ended 31 December, 2003 was approximately RMB3,083,000. The amount of commission paid by the Group to Northern Airlines for the year ended 31 December, 2003 was approximately RMB404,000.

The amounts payable under the above aforesaid transactions are based on the rates stipulated by the CAAC and IATA.

(d) Ticket Sales Arrangement with Xinjiang Airlines

The Group has entered into ticket agency arrangement with Xinjiang Airlines for the sale of the Group's air tickets by Xinjiang Airlines and for the sale of Xinjiang Airlines air tickets by the Group. The selling party charges a commission in the amount of 3% of the ticket price for domestic tickets and 5% to 12% of the ticket price for Hong Kong regional and international tickets. These commission sales are based on the rates stipulated by the CAAC and IATA. The amount of commission paid by Xinjiang Airlines to the Group for the year ended 31 December, 2003 was approximately RMB1,290,000. The amount of commission paid by the Group to Xinjiang Airlines for the year ended 31 December, 2003 was approximately RMB392,000.

The amounts payable under the above aforesaid transactions are based on the rates stipulated by the CAAC and IATA.



REPORT OF THE DIRECTORS (Cont'd)

The Independent Non-Executive Directors of the Company have confirmed to the Board of Directors of the Company that they have reviewed the connected transactions described in (B) through (F) above and have concluded that:

- (a) The transactions have been entered into by the Group in the ordinary and usual course of its business;
- (b) The transactions have been entered into either (i) on normal commercial terms (by reference to transactions of a similar nature made by similar entities within the PRC) or (ii) (where there is no available comparison) on terms that are fair and reasonable so far as the shareholders of the Company are concerned;
- (c) The transactions have been performed either (i) in accordance with the terms of the agreement governing each such transaction or (ii) (where there is no such agreement) on terms no less favourable than terms available from third parties; and
- (d) The aggregate annual amount payable by the Group to CSAHC, and the aggregate annual amount payable by CSAHC to the Group, under the Ongoing Connected Transactions for In-Flight Meals and Ticket Sales for the year ended 31 December, 2003 have not exceeded the higher of HK\$10 million and 3% of the consolidated net tangible assets of the Group as disclosed in its latest published audited accounts.

WAIVER FOR ACQUISITIONS AND DISPOSALS OF AIRCRAFT

In March 2002, the Hong Kong Stock Exchange granted a waiver to allow the Company to use a new size test based on available tonne kilometres ("ATKs") to replace the normal net asset test and consideration test under Chapter 14 of the Listing Rules in respect of acquisitions and disposals of aircraft.

The Hong Kong Stock Exchange has granted the waiver on and subject to the following conditions:

1. Instead of the normal tests under Chapter 14 of the Listing Rules, the tests may be calculated by reference to the ATKs for aircraft being acquired or disposed of as compared to the Company's aggregate fleet ATKs.
2. The proposed method of calculation for the four tests will replace the net asset test and the consideration test only while the other two tests, namely, net profit and equity capital issued tests will continue to apply as set out in Chapter 14 of the Listing Rules.
3. The calculation of ATKs will be as follows: (i) fleet ATKs will be the aggregate actual ATKs for all aircraft in the Company's fleet for the last financial year as disclosed in the Company's annual report, (ii) ATKs for aircraft being disposed of will be based on actual ATKs of the aircraft for the previous two financial years; and (iii) ATKs for aircraft being acquired will be based on the historical operating data for the same type of aircraft. Where the aircraft to be acquired is a new type, the ATKs will be estimated based on other aircraft of similar size operated by the Company or the average for the Chinese civil aviation industry.

**REPORT OF THE DIRECTORS (Cont'd)**

4. The Company's ATKs figure will be disclosed in the Company's annual report and be reviewed by the Company's auditors which will report on an annual basis that the Company's ATKs are calculated correctly and consistently.
5. For the purposes of making the test as stated in paragraph 1 above, all acquisitions and disposals for the last 12 months will be aggregated, unless the acquisition or disposal has previously been reported as a notifiable transaction under these rules.
6. The thresholds for classifying a transaction as a discloseable, major or very substantial acquisition will be 30%, 50% and 100% (assuming that there are no circumstances which would make it a connected transaction or a share transaction).
7. Where the transaction is a discloseable transaction, disclosure will take the form of a press announcement complying with rule 14.14 of the Listing Rules and details of the transaction will be set out in the Company's next annual report and accounts. Where the transaction is a major transaction or a very substantial acquisition, the provisions of Chapter 14 of the Listing Rules will apply.
8. An option to acquire aircraft will not be treated as acquisition while the exercise of such an option will be treated as acquisition of aircraft.
9. The waiver will only apply to acquisition/ disposal of aircraft, and acquisition or disposal of other types of assets by the Company will be subject to provisions under Chapter 14 of the Listing Rules.
10. The Company will disclose in its annual reports and interim reports the following information:
 - (a) Regarding future deliveries of aircraft, details of aircraft on order including the number and type; and the years in which such aircraft are scheduled to be delivered;
 - (b) The number and type of aircraft which are subject to options exercisable during a period of not less than 12 months from the end of the financial year or period to which the annual report relates; and
 - (c) Details of the waiver granted pursuant to the application.
11. The Company remains a subsidiary of the CSAHC. Should there be any change in control of the Company, the Hong Kong Stock Exchange will need to reconsider whether the waiver continues to be appropriate.

Regarding future deliveries of aircraft, details of aircraft on order and the years in which such aircraft are scheduled to be delivered, please refer to note 29 to the financial statements prepared under IFRS. One Boeing 757-200 aircraft and one Boeing 737-300 aircraft are subject to options exercisable in 2004.



REPORT OF THE DIRECTORS (Cont'd)

DONATIONS

During the year, the Group made donations for charitable purposes amounting to RMB2,106,000.

DESIGNATED DEPOSITS AND OVERDUE TIME DEPOSITS

As at 31 December, 2003, the Group's deposits placed with financial institutions or other parties did not include any designated deposits, or overdue time deposits against which the Group failed to receive repayments.

MATERIAL LITIGATION

The Group was not involved in any material litigation or dispute in 2003.

AUDITORS

A resolution is to be proposed at the forthcoming Annual General Meeting of the Company for the reappointment of KPMG as the international auditors of the Company and of KPMG Huazhen as the PRC auditors of the Company.

By Order of the Board of Directors

Yan Zhi Qing

Chairman of the Board of Directors

Guangzhou, the PRC

23 April, 2004