

## Directors' Report

The Directors hereby present to the shareholders their report, together with the audited financial statements of the Group for the year ended 31st December 2005.

### PRINCIPAL ACTIVITIES AND GEOGRAPHICAL ANALYSIS OF OPERATIONS

The principal activity of the Company is investment holding. The principal activities of its subsidiaries, associates and jointly controlled entities are airline operations and aviation related businesses which are set out in notes 18, 19, and 21 to the financial statements respectively.

An analysis of the Group's performance for the year by business and geographical segments is set out in note 6 to the financial statements .

### RESULTS AND APPROPRIATIONS

The results of the Group for the year ended 31st December 2005 and the state of the Group's affairs as at that date are set out in the financial statements on pages 44 to 109.

The Directors have declared an interim dividend of HK0.8 cent per share, totalling HK\$26,501,000, which was paid on 13th October 2005.

The Directors recommend the payment of a final dividend of HK1.0 cent per share, totalling HK\$33,127,000.

### RESERVES

Movements in the reserves of the Group and of the Company during the year are set out in note 28 to the financial statements.

### PROPERTY, PLANT AND EQUIPMENT

Details of the movement of property, plant and equipment of the Group are set out in note 15 to the financial statements.

### SHARE CAPITAL

Details of the movements in share capital of the Company are set out in note 27 to the financial statements.

### DISTRIBUTABLE RESERVES

Distributable reserves of the Company at 31st December 2005, calculated under Section 79B of the Hong Kong Companies Ordinance, amounted to HK\$823,873,000 (2004: HK\$680,033,000).

### FINANCIAL SUMMARY

A summary of the results and of the assets and liabilities of the Group for the last five financial years is set out on page 110.

## Directors' Report (Cont'd)

### REPURCHASE, SALE OR REDEMPTION OF SHARES

Neither the Company nor any of its subsidiaries has repurchased, sold or redeemed any of the Company's shares during the year ended 31st December 2005.

At 31st December 2005, 3,312,680,000 shares were in issue (31st December 2004: 3,312,680,000 shares).

### SHARE OPTIONS

A share option scheme (the "Scheme") was adopted by the Company on 29th May 2002. The major terms of the Scheme are as follows:

1. The purpose of the Scheme is to provide incentives to participants to contribute to the prosperity, business development or growth of the Group and/or to enable the Group to recruit and/or retain high caliber employees and attract resources that are valuable to the Group.
2. The participants of the Scheme are any Director, employee, supplier, customer or other relevant business partners of the Group as invited by the Board.
3. The subscription price determined by the Board will be the higher of (i) the closing price of the Company's share as stated in The Stock Exchange of Hong Kong Limited's ("Stock Exchange") daily quotations sheet on the date of grant; (ii) the average closing price of the Company's share as stated in the Stock Exchange's daily quotations sheets for the five business days immediately preceding the date of grant; and (iii) the nominal value of the Company's shares.
4. The acceptance of grant of share options must be made within 28 days from the date of grant with a non-refundable payment of HK\$1.00 from the grantee.
5. The maximum number of shares over which options may be granted under the Scheme shall not exceed 30 percent of the issued share capital of the Company from time to time.

As at the date of this report, the maximum number of shares available for issue under the Scheme is 331,268,000, being 10 percent of the number of issued share capital of the Company.

6. The maximum number of shares issuable upon exercise of the options granted under the Scheme and any other share option scheme(s) of the Company (whether exercised or outstanding options) to each eligible participant in any 12-month period must not exceed 1 percent of the shares of the Company in issue. Where any further grant of share options to any eligible participant would result in the shares issued and to be issued upon exercise of all options granted or to be granted to such participant (including exercised, cancelled and outstanding options) in the 12-month period representing in aggregate over 1 percent of the shares of the Company in issue, such further grant shall be subject to the issue of a circular by the Company and the shareholders' approval of the Company at a general meeting with the relevant eligible participant and his/her associates abstaining from voting.
7. The exercise period of any option granted under the Scheme must not exceed six years commencing on the date falling three months after the date of grant and expiring on the last day of the said period.
8. The Scheme shall be valid and effective till 28th May 2012.

## SHARE OPTIONS (Cont'd)

During the year no share option has been granted or exercised. As at 31st December 2005, there were 104,378,000 share options outstanding under the Scheme, details of which are as follows:

Name of Grantee	Options held at 1st January and 31st December 2005	Exercise price HK\$	Grant date	Exercise period
Chuang Shih Ping	33,126,000	1.14	25/07/2003	26/10/2003 to 25/10/2009
Zhang Xianlin	33,126,000	1.14	25/07/2003	26/10/2003 to 25/10/2009
Tsang Hing Kwong, Thomas	33,126,000	1.14	25/07/2003	26/10/2003 to 25/10/2009
Gu Tiefei	5,000,000	1.14	25/07/2003	26/10/2003 to 25/10/2009
Total:	104,378,000			

## DIRECTORS

The Directors during the year and up to the date of this report are:

Kong Dong  
Chuang Shih Ping  
Zhang Xianlin  
Zhao Xiaohang  
Tsang Hing Kwong, Thomas  
Gu Tiefei  
Lok Kung Nam\*#  
Hu Hung Lick, Henry\*#  
Ho Tsu Kwok, Charles\*  
Li Kwok Heem, John\*#  
Chan Ching Har, Eliza\*

\* Independent Non-Executive Director

# Audit Committee member

In accordance with Article 98 of the Company's Articles of Association, Messrs. Kong Dong, Lok Kung Nam, Hu Hung Lick, Henry and Ho Tsu Kwok, Charles retire by rotation at the forthcoming annual general meeting and, being eligible, offer themselves for re-election.

All other remaining directors continue in office.

## Directors' Report (Cont'd)

### DIRECTORS' SERVICE CONTRACTS

None of the Directors who are proposed for re-election at the forthcoming annual general meeting has a service contract with the Company or any of its subsidiaries which is not determinable within one year without payment of compensation, other than statutory compensation.

### DIRECTORS' INTERESTS IN CONTRACTS

No contracts of significance in relation to the Group's business to which the Company, its fellow subsidiaries, its subsidiaries or its holding company was a party and in which a Director of the Company had a material interest, whether directly or indirectly, subsisted at the end of the year or at any time during the year.

### BIOGRAPHICAL DETAILS OF DIRECTORS AND SENIOR MANAGEMENT

Biographical details of Directors and senior management are set out on pages 26 to 28.

### DIRECTORS AND CHIEF EXECUTIVE'S INTERESTS AND SHORT POSITIONS IN SHARES, UNDERLYING SHARES AND DEBENTURES

Apart from the interests of the Directors in the share options of the Company are separately disclosed in the "Share Options" above, as at 31st December 2005, none of the directors and the chief executive of the Company and/or any of their respective associates had any interest or deemed interest in the long and short position in the shares, underlying shares and debentures of the Company or any of its associated corporation (within the meaning of Part XV of the Securities and Futures Ordinance ("SFO")) as recorded in the register required to be kept by the Company under Section 352 of the SFO; or as otherwise notified to the Company and the Stock Exchange pursuant to Part XV of the SFO or the Model Code for Securities Transaction by Directors of Listed Companies (the "Model Code").

### DIRECTORS' INTERESTS IN COMPETING BUSINESS

Pursuant to paragraph 8.10(2) of the Listing Rules, Mr. Kong Dong disclosed that he is the Deputy General Manager of CNAH, the ultimate holding company of the Company, and the Vice Chairman and a non-executive director of Air China. CNAH is a state-owned enterprise established in the PRC, Air China is a joint stock limited company incorporated in the PRC, shares of which are listed on the Stock Exchange of Hong Kong Limited and the London Stock Exchange. Air China is engaged in the business of passenger and cargo air transportation services and airport ground handling services and CNAH is its ultimate holding company. As such the business activities of CNAH and Air China compete, or are likely to compete, either directly or indirectly, with the business of the Group.

Nevertheless Mr. Kong is not directly involved in managing Air China's business. The Group is therefore capable of carrying on such business independently of, and at arm's length from the said competing business.

## CHANGE IN IMMEDIATE CONTROLLING SHAREHOLDER

In or about September 2004, CNAH and a number of its subsidiaries underwent a restructuring pursuant to which CNACG transferred its entire interest in the Company to Air China. Consequent to such restructuring, the Company has become a directly-owned subsidiary of Air China of which Air China is directly interested in approximately 69 percent of the issued share capital of the Company. The Hong Kong Securities and Futures Commission has granted a waiver to Air China of its obligation to make a mandatory general offer to all other shareholders of the Company as a result of such restructuring.

## SUBSTANTIAL SHAREHOLDERS

The register of interests in shares and short positions maintained under Part XV of the SFO shows that as at 31st December 2005 the Company had been notified of the following:

Substantial Shareholders	Capacity	Number of shares	Percentage of the issued share capital
China National Aviation Holding Company	Attributable interest	2,264,628,000 (note 1)	68.4%
Air China Limited	Beneficial owner	2,264,628,000 (note 2)	68.4%
Best Strikes Limited	Beneficial owner	187,656,000	5.6%
On Ling Investments Limited	Attributable interest	322,856,000 (note 3)	9.7%
Novel Investments Holdings Limited	Attributable interest	322,856,000 (note 3)	9.7%
Novel Enterprises Limited	Attributable interest	322,856,000 (note 3)	9.7%
Novel Enterprises (BVI) Limited	Attributable interest	322,856,000 (note 3)	9.7%
Novel Credit Limited	Attributable interest	322,856,000 (note 3)	9.7%
Novel Holdings (BVI) Limited	Attributable interest	322,856,000 (note 3)	9.7%
Westleigh Limited	Attributable interest	322,856,000 (note 3)	9.7%

### Notes:

1. A state-owned enterprise established in the People's Republic of China. It owns approximately 51.16 percent of the total issued share capital of Air China Limited and the entire issued share capital of China National Aviation Corporation (Group) Limited, a company incorporated in Hong Kong, which in turn owns approximately 14.64 percent of the total issued share capital of Air China Limited. Accordingly its interests in the Company duplicate with those interest of Air China Limited.
2. A joint stock limited company incorporated in the People's Republic of China with its H shares listed in Hong Kong and London. China National Aviation Corporation (Group) Limited, the Company's former immediate controlling shareholder, transferred its approximately 69 percent shareholding interest in the Company to Air China Limited in September 2004 by way of a capital contribution in return for Air China Limited's non-H foreign shares, as such Air China Limited becomes the immediate controlling shareholder of the Company. Its interest in the Company duplicates with those interests of China National Aviation Holding Company.
3. 5.6 percent of the interest held by each of these companies in the Company duplicates with Best Strikes Limited's interest in the Company. The interests of these companies in the Company also duplicate each other.

Save as disclosed above, as at 31st December 2005, no other person had an interest in the long and short position in the shares or underlying shares of the Company as recorded in the register required to be kept by the Company under Part XV of the SFO.

## Directors' Report (Cont'd)

### MANAGEMENT CONTRACTS

There exist agreements for general management services, in respect of which CNACG and CNAC (Macau) Aviation provide secretarial, personnel, accounting and general office administrative services to the Company and CNAC Macau on monthly fees of HK\$500,000 and HK\$300,000 respectively. Details of which are set out in note 38(a) to the financial statements.

Save as disclosed above, no contracts concerning the management and administration of the whole or any substantial part of the business of the Company were entered into or existed during the year.

### MAJOR CUSTOMERS AND SUPPLIERS

As set out in the section headed "Principal Activities" above, the Group's turnover and operating profit are mainly derived from its airline operations.

During the year, the Group sold approximately 11 percent of its goods and services to its five largest customers.

The largest supplier and the five largest suppliers combined represented 17 percent and 42 percent respectively of the Group's total purchases for the year.

During the year, none of the Directors, their associates or any shareholder (which to the knowledge of the directors owns more than 5 percent of the company's share capital) had an interest in the major suppliers or customers noted above except that the Company owns 33.65 percent effective interests in one of the five largest suppliers and the Company's immediate holding company effectively owns 51 percent effective interests in another one of the five largest suppliers, which together contributed 13 percent of the Group's total purchases.

### CONNECTED TRANSACTIONS

Connected transactions disclosed in accordance with Chapter 14A of the Listing Rules are as follows:

1. BACL entered with Air China for the provision of in-flight catering services and other related in-flight food and beverages services to Air China in respect of all inbound and outbound flights of Air China and its various branch companies and cargo companies, with flight numbers carrying the prefix of the code name for Air China flights ("CA") to and from Beijing Capital International Airport.

The in-flight meal services expenses paid to BACL for the year ended 31st December 2005 amounted to HK\$173,512,000.

2. SWACL entered with Air China for the provision of in-flight catering services and other related in-flight food and beverages services and other ancillary services to Air China, its Southwest and Zhejiang branch companies in respect of all the inbound and outbound flights with flight numbers carrying the prefix of CA to and from Chengdu Shuangliu International Airport operated by those branch companies.

The in-flight meal and other ancillary services expenses paid to SWACL for the period for the year ended 31st December 2005 amounted to HK\$49,876,000 and HK\$1,839,000 respectively.

## CONNECTED TRANSACTIONS (Cont'd)

3. The Group entered into a lease agreement with Easy Advance Limited and Wise Advice Limited, fellow subsidiaries, pursuant to which Easy Advance Limited and Wise Advice Limited lease office premises and certain car parks to the Group at a total monthly rental of MOP141,800 (equivalent to approximately HK\$138,000).
4. The Group entered into a lease agreement with Air China, immediate holding company, pursuant to which the Group leases aircraft to Air China at a monthly fee of US\$358,500 (equivalent to approximately HK\$2,796,000) with monthly maintenance hour charge of US\$470 (equivalent to approximately HK\$4,000) per block hour for the period from 20th October 2004 to 19th April 2005. The lease agreement was then extended by a wet lease extension agreement entered into by both parties for the period from 20th April 2005 to 19th October 2005.
5. On 27th August 2003, the Company and CNACG entered into a management services agreement pursuant to which CNACG has agreed to provide secretarial, personnel, accounting and general office administrative services to the Group for a period of two years and CNACG would be paid by the Company in respect of the services a monthly fee of HK\$500,000.

The management services agreement was renewed on 28th July 2005 with same terms for a period of three years commencing 1st July 2005. Total management fee paid during the year amounted to HK\$6,000,000.

6. The Company acquired the entire equity interest in CNAC Macau consisting, inter alia, 51 percent of Air Macau on 25th March 2002, certain on-going transactions constituted connected transactions of the Company arising therefrom are as follows:
  - (i) Airport charges and airport fees that invoiced and collected by ADA – Administration of Airports Limited (“ADA”), a 51 percent owned subsidiary of CNAC (Macau) Aviation (a wholly-owned subsidiary of CNACG), on behalf of Macau International Airport Company (“MIAC”), the developer and owner of Macau International Airport. Since the Company and CNAC (Macau) Aviation are both subsidiaries of CNACG, ADA is a connected person (as defined under the Listing Rules) of the Group. Further, Sociedade de Turismo e Diversões de Macau (“STDM”), which has a 14 percent shareholding interest in Air Macau, has an approximately 33 percent shareholding in MIAC and hence, MIAC is also a connected person of the Group. As a result, the payment of airport charges and airport fees constitutes connected transactions under the Listing Rules.

The aggregate of the airport charges and airport fees paid to ADA/MIAC for the year ended 31st December 2005 totalling HK\$86,343,000.

## Directors' Report (Cont'd)

### CONNECTED TRANSACTIONS (Cont'd)

- (ii) Air Macau continues to purchase in-flight meals from Macau Catering Services Company Limited ("MCS"), an associate of STDM, pursuant to a catering services agreement that took effect from 1st November 2001.

The aggregate of the in-flight meal services expenses paid to MCS for the year ended 31st December 2005 totalling HK\$46,373,000 did not exceed HK\$65,000,000.

- (iii) CNAC Macau and CNAC (Macau) Aviation entered into a three-year management services agreement pursuant to which CNAC (Macau) Aviation provides general management services including secretarial, personnel, accounting and general office administrative services, to CNAC Macau, at a monthly fee of HK\$300,000.

The aggregate of the services fees paid during the year ended 31st December 2005 totalling HK\$3,600,000 did not exceed HK\$4,000,000.

- (iv) Air Macau has entered into sales arrangement with certain ticket sales agents, the number of which may be varied from time to time according to the business needs of Air Macau, for the sale of air tickets (including cargo transport). During the year, Air Macau either sold the air tickets to the ultimate consumers through the ticket sales agents and paid to the ticket sales agents commission fees at rates of 7 percent to 9 percent of the value of tickets sold; or sold the air tickets to the ticket sales agents at fixed prices, so that the ticket sales agents might on-sale the same to ultimate consumers at prices determined by the ticket sales agents. Such ticket sales agents include those who are also associates of CNACG or CNAC, the immediate holding company of CNACG.

The aggregate of the commission paid or payable to, and value of tickets sold to those agents for the year ended 31st December 2005 totalling HK\$15,355,000.

7. BACL entered into a project management services agreement on 4th November 2005 with Air China Beijing Construction Base Command Centre ("Air China Command Centre"). Pursuant to which Air China Command Centre agreed to provide services in respect of phase 3 of the construction work for the expansion of the ancillary facilities in the Beijing Capital International Airport (the "Project") and BACL agreed to pay at a management fee which is equivalent to 2.5% of the approved budget of the construction for the Project. The management fee payable by BACL to Air China Command Centre shall be RMB7,771,250 (equivalent to approximately HK\$7,500,000). The project management fee paid to Air China Command Centre during the year ended 31st December 2005 was HK\$1,344,000.

The independent Non-Executive Directors have reviewed these transactions and confirmed that in their opinion, these transactions were carried out:

- (i) in the ordinary and usual course of business;
- (ii) on normal commercial terms; and
- (iii) in accordance with the relevant agreement (if applicable) on terms that are fair and reasonable and in the interests of the independent shareholders of the Company as a whole.



## CONNECTED TRANSACTIONS (Cont'd)

The auditors of the Company have performed certain procedures on the continuing connected transactions in accordance with Hong Kong Standard on Related Services 4400 "Engagements to Perform Agreed-Upon Procedures Regarding Financial Information" issued by the Hong Kong Institute of Certified Public Accountants and reported that:

- (i) the transactions as set out in items (1), (2), (3), (4), (5) and (6) above were approved by the Board of Directors of the Company;
- (ii) the pricing of the transactions (for the samples selected) as set out in items (1), (2), (4) and (6)(iv) above was entered into in accordance with the pricing policies of the Group;
- (iii) the transactions (for the samples selected) as set out in items (1), (2), (3), (4), (5), (6)(ii), (6)(iii) and (6)(iv) above were entered into in accordance with the relevant agreements governing the transactions or to the rates published by the Macau Government in the government gazette for transactions as set out in item 7(i) where there was no such agreement/contract;
- (iv) the aggregate of each type of transactions as set out in items (1), (2), (3), (4), (5), (6)(ii) and (6)(iii) had not exceeded the corresponding cap amounts as disclosed in the Company's announcement/circulars, and the aggregate of each type of transactions as set out in items (6)(i) and (6)(iv) which did not have corresponding cap amounts as disclosed in the Company's circulars.

## FINANCIAL ASSISTANCE TO AFFILIATED COMPANIES AND THEIR PROFORMA COMBINED BALANCE SHEET

Pursuant to Chapter 13 of the Listing Rules, a proforma combined balance sheet of those affiliated companies with financial assistance from the Group and the Group's attributable interest in those affiliated companies are presented below.

Affiliated companies comprise the Group's associates and jointly controlled entities. As at 31st December 2005, the Group had loans to affiliated companies totalling HK\$65,603,000 and had given guarantees of HK\$442,545,000 in respect of facilities granted to and provide sufficient funding for an infrastructure development of an affiliated company, financial assistance totalling HK\$508,148,000. These exceed 8% of the Group's total assets as at 31st December 2005.

	<b>As at 31st December 2005</b>	
	<b>Proforma combined balance sheet HK\$'000</b>	<b>The Group's attributable interest HK\$'000</b>
Non-current assets	561,089	207,287
Current assets	483,786	239,677
Current liabilities	(328,424)	(162,938)
Non-current liabilities	(279,582)	(75,287)
Minority interests	(29,216)	(14,608)
Shareholders' advances	(226,066)	(65,603)

## Directors' Report (Cont'd)

### SUFFICIENCY OF PUBLIC FLOAT

The Company has maintained a sufficient public float throughout the year ended 31st December 2005.

### AUDITORS

The financial statements have been audited by PricewaterhouseCoopers who retire and, being eligible, offer themselves for re-appointment.

On behalf of the Board

**Kong Dong**

*Chairman*

Hong Kong, 24th March 2006