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If you have sold or transferred all your shares in China National Aviation Company Limited, you should at once hand this document and the accompanying forms of proxy to the purchaser or transferee or to the bank, the licensed securities dealer or registered institution in securities or other agent through whom the sale or transfer was effected for transmission to the purchaser or transferee.

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中航興業有限公司

CHINA NATIONAL AVIATION COMPANY LIMITED

(incorporated in Hong Kong with limited liability)

(Stock Code: 1110)

PROPOSED PRIVATIZATION BY



中國國際航空股份有限公司

AIR CHINA LIMITED

(incorporated in the PRC with limited liability)

(Stock Code: 753)

**BY WAY OF A SCHEME OF ARRANGEMENT
UNDER SECTION 166 OF THE COMPANIES ORDINANCE**

Financial adviser to China National Aviation Company Limited



Citigroup Global Markets Asia Limited

Independent financial adviser to the Independent Board Committee
of China National Aviation Company Limited



CLSA Equity Capital Markets Limited

Exclusive financial advisers to Air China Limited



CICC
中國國際金融(香港)有限公司
CHINA INTERNATIONAL CAPITAL
CORPORATION (HONGKONG) LIMITED



Merrill Lynch

**China International Capital Corporation
(Hong Kong) Limited**

**Merrill Lynch
(Asia Pacific) Limited**

A letter from the board of directors of China National Aviation Company Limited is set out on pages 7 to 11 of this document. An explanatory statement regarding the privatization proposal is set out on pages 32 to 49 of this document. A letter from the Independent Board Committee (as defined herein) containing its advice to the Minority Shareholders (as defined herein) and the holders of Options (as defined herein) in relation to the privatization proposal is set out on page 12 of this document. A letter from CLSA Equity Capital Markets Limited containing its advice to the Independent Board Committee in relation to the privatization proposal is set out on pages 13 to 31 of this document.

The actions to be taken by the Minority Shareholders are set out on page 48 of this document.

Notices convening the Court Meeting (as defined herein) and the Extraordinary General Meeting (as defined herein) of China National Aviation Company Limited to be held at Tianshan – Lushan Room, Level 5, Island Shangri-La, Hong Kong, Pacific Place, Supreme Court Road, Central, Hong Kong on 15 December 2006 at 11:00 a.m. and 11:30 a.m. or immediately following the Court Meeting, respectively, are set out on pages 150 to 153 of this document. Whether or not you intend to attend the Court Meeting or the Extraordinary General Meeting, you are strongly urged to complete and sign the enclosed pink form of proxy in respect of the Court Meeting and the enclosed white form of proxy in respect of the Extraordinary General Meeting in accordance with the instructions respectively printed thereon and return the same to the share registrar of China National Aviation Company Limited, Computershare Hong Kong Investor Services Limited, at 17th Floor, Hopewell Centre, 183 Queen's Road East, Hong Kong as soon as possible and in any event not less than 48 hours before the time appointed for the holding of the relevant meeting. In the case of the pink form of proxy in respect of the Court Meeting, it may alternatively be handed to the chairman of the Court Meeting at the Court Meeting if it is not so delivered. Completion and return of the forms of proxy will not preclude a member from attending and voting in person at the relevant meeting or any such adjourned meeting if the member so wishes. In such event, the relevant form of proxy shall be deemed to have been revoked.

16 November 2006

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DEFINITIONS

In this document, the following expressions shall have the meanings respectively set opposite them unless the context requires otherwise:

“acting in concert”	has the meaning ascribed to it in the Takeovers Code
“Air China”	Air China Limited (中國國際航空股份有限公司), a company incorporated in the PRC with limited liability and the shares of which are listed on the Main Board of the Stock Exchange (stock code 753), the Shanghai Stock Exchange (stock code 601111) and the London Stock Exchange (stock code AIRC)
“Air China Group”	Air China and its subsidiaries
“Air Macau”	Air Macau Company Limited, a private company incorporated in Macau with limited liability and a subsidiary of CNAC
“Announcement”	the announcement dated 21 June 2006 issued jointly by CNAC and Air China relating to, amongst other things, the proposal for CNAC to become a private company within the Air China Group
“Cathay”	Cathay Pacific Airways Limited, a company incorporated in Hong Kong with limited liability and the shares of which are listed on the Main Board of the Stock Exchange (stock code 293)
“CICC”	China International Capital Corporation (Hong Kong) Limited, a corporation licensed under the SFO to conduct type 1 (dealing in securities), type 4 (advising on securities), type 6 (advising on corporate finance) and type 9 (asset management) of the regulated activities and an exclusive financial adviser to Air China in relation to the privatization proposal
“Citigroup”	Citigroup Global Markets Asia Limited, a corporation licensed under the SFO to conduct type 1 (dealing in securities), type 4 (advising on securities), type 6 (advising on corporate finance) and type 7 (providing automated trading services) of the regulated activities and the financial adviser to CNAC in relation to the privatization proposal
“CLSA”	CLSA Equity Capital Markets Limited, a corporation licensed under the SFO to conduct type 4 (advising on securities) and type 6 (advising on corporate finance) of the regulated activities and the independent financial adviser appointed to advise the Independent Board Committee in respect of the Scheme and Air China’s proposal to cancel the outstanding Options

DEFINITIONS

“CNAC”	China National Aviation Company Limited (中航興業有限公司), a company incorporated in Hong Kong with limited liability and the shares of which are listed on the Main Board of the Stock Exchange (stock code 1110)
“CNAC Board”	board of directors of CNAC
“CNAC Group”	CNAC and its subsidiaries
“Companies Ordinance”	Companies Ordinance, Chapter 32 of the Laws of Hong Kong
“Conditions”	the conditions to which the privatization proposal is subject, as set out under the section headed “Conditions of the Scheme” in the Explanatory Statement
“Court”	High Court of Hong Kong
“Court Meeting”	the meeting of the Minority Shareholders to be convened at the direction of the Court for the purpose of approving the Scheme, notice of which is set out on pages 150 and 151 of this document, and any adjournment thereof
“Dragonair”	Hong Kong Dragon Airlines Limited (港龍航空有限公司), a private company incorporated in Hong Kong with limited liability
“Effective Date”	the date on which the Scheme, if approved, becomes effective, which is expected to be 10 January 2007
“Executive”	Executive Director of the Corporate Finance Division of the SFC or any delegate of the Executive Director
“Explanatory Statement”	the explanatory statement set out on pages 32 to 49 of this document and issued in compliance with Section 166A of the Companies Ordinance
“Extraordinary General Meeting”	the extraordinary general meeting of CNAC to be convened for the purposes of approving and implementing the Scheme and the reduction of capital involved in the Scheme, notice of which is set out on pages 152 and 153 of this document, and any adjournment thereof

DEFINITIONS

“HK\$”	Hong Kong dollars, the lawful currency of Hong Kong
“Hong Kong”	Hong Kong Special Administrative Region of the PRC
“Independent Board Committee”	an independent committee of the CNAC Board comprising all of its independent non-executive directors other than Hu Hung Lick, Henry and appointed for the purpose of advising the Minority Shareholders in respect of the Scheme and the Option holders in respect of Air China’s proposal to cancel the outstanding Options
“Last Trading Date”	2 June 2006, being the last trading day prior to the publication of the joint announcement dated 8 June 2006 by Air China, Cathay, CITIC Pacific Limited, CNAC and Swire Pacific Limited in relation to, amongst other things, the Restructuring Agreement
“Latest Practicable Date”	13 November 2006, being the latest practicable date prior to the printing of this document for the purpose of ascertaining certain information contained herein
“Listing Rules”	Rules Governing the Listing of Securities on the Stock Exchange
“Macau”	Macau Special Administrative Region of the PRC
“Merrill Lynch”	Merrill Lynch (Asia Pacific) Limited, a corporation licensed under the SFO to conduct type 1 (dealing in securities), type 4 (advising on securities), type 6 (advising on corporate finance) and type 7 (providing automated trading services) of the regulated activities and an exclusive financial adviser to Air China in relation to the privatization proposal
“Merrill Lynch International”	a private unlimited company incorporated under the laws of England and Wales and recognized by the Executive as an exempt principal trader under the Takeovers Code
“Merrill Lynch PF&S”	Merrill Lynch, Pierce, Fenner & Smith Incorporated, a corporation established under the laws of the United States of America and which is presumed to be acting in concert with Air China under the Takeovers Code
“Minority Shareholder(s)”	registered holder(s) of the Shares other than Air China
“MOP”	Macanese pataca, the lawful currency of Macau
“Most Known Investments”	Most Known Investments Limited, a company incorporated in the British Virgin Islands with limited liability and a subsidiary of Air China

DEFINITIONS

“Options”	options granted pursuant to the share option scheme adopted by CNAC on 29 May 2002 entitling the grantees of such options to subscribe for the Shares at an exercise price of HK\$1.14 per Share
“PRC”	People’s Republic of China
“Record Time”	4:00 p.m. Hong Kong time on the trading day immediately preceding the Effective Date
“Restructuring Agreement”	the agreement dated 8 June 2006 entered into amongst Air China, Cathay, CITIC Pacific Limited, CNAC and Swire Pacific Limited, as supplemented by a further agreement dated 21 September 2006, for the purpose of restructuring the parties’ shareholdings in Cathay and in Dragonair and the acquisition by Cathay of additional shares in Air China
“Scheme”	the scheme of arrangement between CNAC and the holders of the Scheme Shares under Section 166 of the Companies Ordinance as set out on pages 143 to 149 of this document, with or subject to any modification thereof or addition thereto or conditions approved or imposed by the Court
“Scheme Share(s)”	the Share(s) in issue at the Record Time other than those registered in the name of Air China
“SFC”	Securities and Futures Commission of Hong Kong
“SFO”	Securities and Futures Ordinance, Chapter 571 of the Laws of Hong Kong
“Shares”	ordinary shares of HK\$0.10 each in the capital of CNAC
“Stock Exchange”	The Stock Exchange of Hong Kong Limited
“subsidiary”	has the meaning ascribed to it in Section 2 of the Companies Ordinance
“Takeovers Code”	Code on Takeovers and Mergers issued by the SFC
“US\$”	United States dollar, the lawful currency of the United States of America
“%”	per cent

EXPECTED TIMETABLE

Latest time for lodging transfers of the Shares in order
to be entitled to attend and vote at the Court Meeting
and the Extraordinary General Meeting 4:00 p.m. on Tuesday,
12 December 2006

Latest time for lodging forms of proxy in respect of:

Court Meeting (*Note 1*) 11:00 a.m. on Wednesday, 13 December 2006

Extraordinary General Meeting (*Note 1*) 11:30 a.m. on Wednesday,
13 December 2006

Suspension of dealings in the Shares 9:30 a.m. on Friday, 15 December 2006

Court Meeting 11:00 a.m. on Friday, 15 December 2006

Extraordinary General Meeting 11:30 a.m. on Friday, 15 December 2006

Press announcement of results of the Court Meeting and
Extraordinary General Meeting Monday, 18 December 2006

Resumption of dealings in the Shares 9:30 a.m. on Monday, 18 December 2006

Last day for dealing in the Shares Thursday, 4 January 2007

Latest time for lodging transfers of the Shares in
order to be registered as a member of CNAC
at the Record Time 4:00 p.m. on Monday, 8 January 2007

Court hearing of petition to sanction the Scheme Tuesday, 9 January 2007

Record Time 4:00 p.m. on Tuesday, 9 January 2007

Press announcement of the result of the Court hearing
of the petition to sanction the Scheme Wednesday, 10 January 2007

Effective Date (*Note 2*) Wednesday, 10 January 2007

Withdrawal of the listing of the Shares
on the Stock Exchange 9:30 a.m. on Thursday, 11 January 2007

Press announcement of the Effective Date and the
withdrawal of the listing of the Shares Thursday, 11 January 2007

Cheques for payments of monetary entitlements
under the Scheme despatched on or before Saturday, 20 January 2007

EXPECTED TIMETABLE

Shareholders should note that the above timetable is subject to change as it is mainly dependent on the availability of the dates for the Court to hear the proceedings for the sanction of the Scheme. Further announcement(s) will be made in the event that there is any change to the timetable.

Notes:

1. Forms of proxy should be lodged with the share registrar of CNAC, Computershare Hong Kong Investor Services Limited, as soon as possible and by the times and dates stated above. The address of the share registrar is situate at 17th Floor, Hopewell Centre, 183 Queen's Road East, Hong Kong. In the case of the pink form of proxy in respect of the Court Meeting, it may be handed to the chairman of the Court Meeting at the Court Meeting if it is not so lodged. In order to be valid, the white form of proxy for the Extraordinary General Meeting must be lodged no later than the time and date stated above. Completion and return of a form of proxy for either of the Meetings will not preclude such shareholder from attending the Court Meeting or the Extraordinary General Meeting and voting in person if he so wishes. In such event, the returned form of proxy will be deemed to have been revoked.
2. The Scheme will become effective when it is sanctioned (with or without modification) by the Court and an office copy of the order of the Court, together with the minute containing the particulars required by Section 61 of the Companies Ordinance, are delivered to and registered by the Registrar of Companies. Registration is expected to take place on 10 January 2007. The Minority Shareholders should note the Conditions set out in the Explanatory Statement on pages 35 and 36 of this document. If the Scheme becomes effective, it is expected that the listing of the Shares on the Stock Exchange will be withdrawn on 11 January 2007.

LETTER FROM THE CNAC BOARD



中航興業有限公司

CHINA NATIONAL AVIATION COMPANY LIMITED

(incorporated in Hong Kong with limited liability)

(Stock Code: 1110)

Executive Directors

Kong Dong (*Chairman*)

Chuang Shih Ping

Zhang Xianlin

Zhao Xiaohang

Tsang Hing Kwong, Thomas

Gu Tiefei

Registered Office:

5th Floor

CNAC House

12 Tung Fai Road

Hong Kong International Airport

Lantau

Hong Kong

Independent Non-Executive Directors

Lok Kung Nam

Hu Hung Lick, Henry

Ho Tsu Kwok, Charles

Li Kwok Heem, John

Chan Ching Har, Eliza

Principal Office:

5th Floor

CNAC House

12 Tung Fai Road

Hong Kong International Airport

Lantau

Hong Kong

16 November 2006

To the Minority Shareholders and, for information only, holders of Options

Dear Sir or Madam,

**PROPOSED PRIVATIZATION OF
CHINA NATIONAL AVIATION COMPANY LIMITED
BY AIR CHINA LIMITED
BY WAY OF A SCHEME OF ARRANGEMENT
UNDER SECTION 166 OF THE COMPANIES ORDINANCE**

INTRODUCTION

On 21 June 2006, CNAC and Air China, which holds a controlling interest of 68.4% in CNAC, jointly announced that, subject to the completion of the transactions contemplated under the Restructuring Agreement, Air China would make a proposal for the privatization of CNAC by way of a scheme of arrangement under Section 166 of the Companies Ordinance. The privatization proposal was engendered by the matters described in the section entitled "Background to the Proposal" in the Explanatory Statement to which the Minority Shareholders are referred. The transactions contemplated under the Restructuring Agreement were completed on 28 September 2006. Accordingly, the CNAC Board now puts forward the privatization proposal to the Minority Shareholders which it believes to be in the interest of CNAC.

LETTER FROM THE CNAC BOARD

Upon the Scheme becoming effective, CNAC will become a private company within the Air China Group and the listing of the Shares on the Stock Exchange will be withdrawn. Citigroup has been appointed by CNAC as its financial adviser in connection with the privatization proposal. CICC and Merrill Lynch have been appointed by Air China as its exclusive financial advisers in connection with the same proposal.

As at the Latest Practicable Date, there were 3,312,680,000 Shares in issue and 104,378,000 outstanding Options. Air China, together with Merrill Lynch PF&S as a party acting in concert with it, was interested in an aggregate of 2,264,642,000 Shares, representing approximately 68.4% of the issued capital of CNAC. Save as disclosed in this paragraph, no other parties acting in concert with Air China were interested in the Shares as at the Latest Practicable Date.

The CNAC Board consists of six executive directors. Amongst them, Mr. Kong Dong is a director of Air China, Mr. Zhang Xianlin is the chairman of the supervisory board of Air China and Mr. Zhao Xiaohang was nominated to the CNAC Board by Air China. Messrs. Kong Dong, Zhang Xianlin and Zhao Xiaohang are therefore parties acting in concert with Air China. Moreover, Messrs. Chuang Shih Ping, Zhang Xianlin, Tsang Hing Kwong, Thomas and Gu Tiefei are holders of the outstanding Options. All of them are therefore not considered to be independent under the Takeovers Code to opine on the terms of the privatization proposal. As to the five independent non-executive directors on the CNAC Board, only Mr. Hu Hung Lick, Henry, who is also an independent non-executive director of Air China and is therefore presumed to be a party acting in concert with Air China, is considered to be not independent under the Takeovers Code to express any view on the merits of the privatization proposal. Hence, the Independent Board Committee, which comprises all of the independent non-executive directors of CNAC other than Mr. Hu Hung Lick, Henry, was formed for the purpose of advising the Minority Shareholders and the holders of the outstanding Options in respect of the privatization proposal. The members of the Independent Board Committee are all independent under the Takeovers Code to opine on the privatization proposal.

CLSA has been appointed by the CNAC Board as the independent financial adviser to advise the Independent Board Committee in connection with the privatization proposal. Such appointment has been approved by the Independent Board Committee.

SUMMARY OF THE PRIVATIZATION PROPOSAL

The purpose of this document is to provide the Minority Shareholders with further information regarding the privatization proposal and to give them notices of the Court Meeting and the Extraordinary General Meeting. The attention of the Minority Shareholders is also drawn to the letters from the Independent Board Committee and CLSA, the Explanatory Statement and the Scheme, all of which form part of this document.

It is proposed that, subject to the Conditions described in the section headed "Conditions of the Scheme" in the Explanatory Statement being fulfilled or waived (as applicable), the privatization proposal will be implemented by way of the Scheme and, to the extent that they have not been exercised so as to result in being the Shares in issue at

LETTER FROM THE CNAC BOARD

the Record Time, the cancellation of all of the outstanding Options. The Scheme itself will involve a reduction in the authorized and issued capital of CNAC by the cancellation of all of the Scheme Shares. Upon the reduction taking effect, the authorized share capital of CNAC will be restored to its former amount by the creation of new Shares, which will be equal to the number of the Scheme Shares cancelled. With the credit arising from the reduction, the new Shares so created will be credited as fully paid and, in accordance with the direction of Air China, issued to Most Known Investments. In exchange for the cancellation of their Scheme Shares, all of the holders of the Scheme Shares will be entitled to receive

HK\$2.80 for every Scheme Share held.

As part of the proposal but separate from the Scheme, Air China also proposes to offer, subject to and conditional upon the Scheme becoming effective, to all of the holders, the sum of HK\$1.66 for every outstanding Option surrendered to CNAC for cancellation. The price of HK\$1.66 for every Option surrendered was determined by reference to the difference between HK\$2.80 for the cancellation of a Scheme Share and the exercise price of HK\$1.14 in respect of each Option. A letter from Air China to the holders of the outstanding Options setting out the terms of the proposal will be despatched to them on the same day as the despatch of this document. As at the Latest Practicable Date, there were 104,378,000 outstanding Options which were held by Messrs. Zhang Xianlin, Gu Tiefei, Chuang Shih Ping and Tsang Hing Kwong, Thomas, all being executive directors of CNAC. Each of Messrs. Zhang Xianlin and Gu Tiefei, holding respectively 33,126,000 and 5,000,000 Options, has undertaken to CNAC and Air China that he would neither accept any of Air China's proposed offer to acquire his outstanding Options for cancellation nor would he exercise any of his Options before their expiry. Each of Messrs. Chuang Shih Ping and Tsang Hing Kwong, Thomas, together holding a total of 66,252,000 Options, has also irrevocably undertaken to CNAC and Air China that to the extent that any of his Options remained unexercised on the day of the hearing of the petition for the sanction of the Scheme by the Court, subject to the Scheme becoming effective, he would not exercise any of such Options as from that day and would accept the proposal by Air China for their cancellation provided that the consideration for the cancellation should be HK\$1.66 per Option. If either of these parties has exercised any of his Options so as to become entitled to attend and vote at the Court Meeting, Mr. Chuang Shih Ping has indicated that he would vote in favour of the resolution for the approval of the Scheme and Mr. Tsang Hing Kwong, Thomas has indicated that he would voluntarily abstain from voting on the same resolution.

Save as disclosed above, as at the Latest Practicable Date, there were no other outstanding options, warrants, derivatives or other securities issued by CNAC carrying a right to subscribe for or which would be convertible into the Shares.

On the basis of HK\$2.80 for each Scheme Share cancelled and assuming that the 1,048,052,000 Shares held by the Minority Shareholders as at the Latest Practicable Date will all constitute the Scheme Shares, the consideration for the cancellation is valued at approximately HK\$2,934.5 million.

LETTER FROM THE CNAC BOARD

There were 104,378,000 outstanding Options as at the Latest Practicable Date. Assuming that all of these Options remain outstanding on the day of the sanction of the Scheme by the Court and on the basis of a consideration of HK\$1.66 payable for the cancellation of each of these Options, the proposal is valued at HK\$173.3 million. If the holders of these outstanding Options become holders of the Scheme Shares, the consideration payable by Air China for the privatization of CNAC will accordingly be increased to approximately HK\$3,226.8 million.

Air China intends to fund the cash required to effect the privatization from bank borrowings in the PRC. CICC and Merrill Lynch, the exclusive financial advisers to Air China in respect of the privatization, are satisfied that sufficient financial resources are available to Air China to implement the Scheme and the proposal in respect of the cancellation of the outstanding Options.

The Scheme will become effective and binding on CNAC and all of the holders of the Scheme Shares, subject to the satisfaction or, if applicable, waiver of the Conditions.

The Scheme will lapse if it is withdrawn or does not become effective on or before 10 April 2007 or such later date as the Court may allow. In such event, the Minority Shareholders will be notified by way of a press announcement.

Assuming that the Scheme becomes effective on 10 January 2007, cheques for payment of the monetary entitlements under the Scheme will be despatched to the holders of the Scheme Shares on or before 20 January 2007.

Further announcement of any change regarding the timetable for the privatization proposal will be made as and when appropriate.

EFFECTS OF, REASONS FOR AND BENEFITS OF THE PROPOSAL AND INFORMATION ON THE CNAC GROUP AND THE AIR CHINA GROUP

The Minority Shareholders are urged to read carefully the relevant sections in the Explanatory Statement concerning the effects of, reasons for and benefits of the privatization proposal as well as the sections relating to the information on the CNAC Group and the Air China Group.

COURT MEETING AND EXTRAORDINARY GENERAL MEETING

Specifically, the Minority Shareholders' attention is drawn to the sections headed "Court Meeting and Extraordinary General Meeting" and "Actions to be taken" in the Explanatory Statement appearing, respectively, on page 47 and page 48 of this document.

The notices of the Court Meeting and the Extraordinary General Meeting are set out on pages 150 to 153 of this document.

LETTER FROM THE CNAC BOARD

FURTHER INFORMATION

A letter from the Independent Board Committee which contains its recommendation to the Minority Shareholders and Option holders in connection with the privatization proposal is set out on page 12 of this document. A letter from CLSA which contains its advice to the Independent Board Committee in connection with the privatization proposal is also set out on pages 13 to 31 of this document. In addition, the Explanatory Statement in respect of the Scheme, together with Appendices, as well as the terms of the Scheme appear on pages 32 to 142 and 143 to 149 respectively of this document. The CNAC Board advises the Minority Shareholders to read such letters and documents carefully before they take any action in respect of the proposal.

In considering what actions to take in respect of the Scheme, the Minority Shareholders should consider their own tax position and, if they are in any doubt as to the taxation or other implications resulting from the Scheme becoming effective or otherwise, they should consult their professional advisers. It is emphasised that none of CNAC, Air China, Citigroup, CLSA, CICC or Merrill Lynch or any of their respective officers or any other person involved in the privatization proposal accepts responsibility for any tax or other effects on, or liabilities of, any person or persons as a result of the implementation or otherwise of the privatization proposal.

The Minority Shareholders should be aware that the implementation of the proposal to privatize CNAC is subject to the Conditions being fulfilled or waived (as applicable) and, accordingly, may or may not become effective. In the meantime, the Minority Shareholders are reminded to exercise caution when dealing in the Shares.

Yours faithfully,
Kong Dong
Chairman

For and on behalf of the Board of
China National Aviation Company Limited

LETTER FROM THE INDEPENDENT BOARD COMMITTEE



中航興業有限公司

CHINA NATIONAL AVIATION COMPANY LIMITED
(incorporated in Hong Kong with limited liability)

(Stock Code: 1110)

16 November 2006

To the Minority Shareholders and the Option holders

Dear Sir or Madam,

PROPOSED PRIVATIZATION OF CHINA NATIONAL AVIATION COMPANY LIMITED BY AIR CHINA LIMITED

We refer to the document of even date jointly issued by Air China and CNAC (the "Document") of which this letter forms part. Terms defined in the Document shall have the same meanings in this letter unless the context otherwise requires.

We have been appointed by the CNAC Board as the Independent Board Committee to make recommendations to the Minority Shareholders on the Scheme and to the holders of the Options in respect of Air China's proposal to cancel the outstanding Options.

Having considered the terms and conditions of the privatization proposal and taking into account the advice of CLSA, in particular the factors, reasons and recommendations as set out in the letter from CLSA set out on pages 13 to 31 of the Document, we consider that the terms of the proposal, in particular the price of HK\$2.80 for the cancellation of a Scheme Share and the price of HK\$1.66 for the cancellation of an Option, are fair and reasonable in so far as the Minority Shareholders and the holders of the Options, respectively, are concerned.

Accordingly, we recommend the Minority Shareholders to approve the Scheme at the Court Meeting to be convened on 15 December 2006 and to vote in favour of the special resolution to be proposed at the Extraordinary General Meeting to be convened on the same date. We also recommend the Option holders to accept Air China's proposal to cancel any Options which remain outstanding as at the day of the hearing of the petition for the sanction of the Scheme by the Court.

The Independent Board Committee draws the attention of the Minority Shareholders and the Option holders to (i) the letter from the CNAC Board on pages 7 to 11 of the Document; (ii) the Explanatory Statement on pages 32 to 49 of the Document; and (iii) the letter from CLSA which sets out the factors and reasons taken into account in arriving at its recommendation to the Independent Board Committee.

Yours faithfully,

**Lok Kung Nam, Ho Tsu Kwok Charles,
Li Kwok Heem John and Chan Ching Har Eliza**
Independent Board Committee

LETTER FROM CLSA

The following is the full text of the letter from CLSA Equity Capital Markets Limited, the independent financial adviser to the Independent Board Committee, in relation to the privatization of CNAC by way of a scheme of arrangement, which has been prepared for the purpose of inclusion in this document.



16 November 2006

To the Independent Board Committee of China National Aviation Company Limited

Dear Sirs,

**PROPOSED PRIVATIZATION OF
CHINA NATIONAL AVIATION COMPANY LIMITED
BY AIR CHINA LIMITED
BY WAY OF A SCHEME OF ARRANGEMENT
UNDER SECTION 166 OF THE COMPANIES ORDINANCE**

INTRODUCTION

We refer to our engagement pursuant to which CLSA has been appointed as the independent financial adviser to advise the Independent Board Committee, the Minority Shareholders and holders of Options (the "**Optionholders**") as to whether or not the terms and conditions of the proposal to privatize CNAC pursuant to the Scheme and the proposal to cancel all outstanding Options (together the "**Proposals**"), and more particularly, the cancellation price of HK\$2.80 per Scheme Share (the "**Share Proposal Price**") and HK\$1.66 per outstanding Option (the "**Option Proposal Price**"), as defined and detailed herein below, are fair and reasonable so far as the Minority Shareholders and Optionholders, respectively, are concerned.

This letter has been prepared for inclusion in this document. Capitalised terms used in this letter shall have the same meanings as defined in this document unless the context otherwise requires.

INDEPENDENT BOARD COMMITTEE

Pursuant to the resolutions of the CNAC Board dated 1 June 2006 and 19 June 2006, the following independent non-executive directors of CNAC, being Mr. Lok Kung Nam, Mr. Ho Tsu Kwok, Charles, Mr. Li Kwok Heem, John, and Ms. Chan Ching Har, Eliza, were appointed as members of the Independent Board Committee for the purposes of advising the Minority Shareholders and Optionholders in respect of the Scheme and the Option proposal, respectively.

LETTER FROM CLSA

The remaining independent non-executive director of CNAC, Mr. Hu Hung Lick, Henry has not been appointed as a member of the Independent Board Committee as Mr. Hu Hung Lick, Henry is also an independent non-executive director of Air China.

The Independent Board Committee has been constituted to advise the Minority Shareholders and Optionholders in respect of the resolution to approve the proposal to holders of Scheme Shares for the cancellation of all Scheme Shares pursuant to the Scheme (the “**Share Proposal**”) and the proposal to Optionholders for cancellation of all outstanding Options (the “**Option Proposal**”), respectively. We have been appointed as the independent financial adviser to advise the Independent Board Committee on the Proposals.

BASIS OF OUR OPINION

In formulating our opinion with regard to the Proposals, we have relied on the information, opinions and facts supplied, and representations made, to us by the directors and representatives of CNAC (including those contained or referred to in this document, the joint announcement issued by Air China, CNAC, Cathay, CITIC Pacific Limited and Swire Pacific Limited dated 8 June 2006 (the “**Joint Announcement**”), the circular issued by CNAC to its shareholders dated 30 June 2006 (the “**Circular**”) and the Announcement). We have assumed that all such information, opinions, facts and representations which have been provided to us by the directors, and representatives of CNAC, and for which they are wholly responsible, are true and accurate in all material respects. We have also relied on certain information available to the public and we have assumed such information to be accurate and reliable, and we have not independently verified the accuracy of such information. Further, we have relied on the representations of the directors of CNAC that they have made all reasonable inquiries, and that, to the best of their knowledge and belief, there are no other facts, the omission of which would make any statement contained in this document, the Joint Announcement, the Circular or the Announcement untrue or misleading. We have also assumed that statements and representations made or referred to in this document, the Joint Announcement, the Circular and the Announcement were accurate at the time they were made and continue to be accurate at the date of despatch of this document.

We consider that we have reviewed sufficient information to enable us to reach an informed view regarding the Proposals to justify our recommendation, relying on the accuracy of the information provided in this document, the Joint Announcement, the Circular and the Announcement as well as to provide a reasonable basis for our advice. As the independent financial adviser to the Independent Board Committee, we have not been involved in the negotiations in respect of the terms and conditions of the Proposals. Our opinion with regard to the terms and conditions thereof has been made on the assumption that all obligations to be performed by CNAC and Air China in relation to the Proposals will be fully performed in accordance with the terms and conditions thereof. Further, we have no reason to suspect that any material facts or information have been omitted or withheld from the information supplied or opinions expressed to us nor to doubt the truth, accuracy and completeness of the information, facts and representations

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provided, or the reasonableness of the opinions expressed, to us by CNAC, its directors and its representatives. In line with normal practice, we have not, however, made any independent verification of the information and facts provided, representations made or opinions expressed by CNAC, its directors and its representatives, nor have we conducted any form of independent investigation into the business affairs or assets and liabilities of the CNAC Group. Accordingly, we do not warrant the accuracy or completeness of any such information.

Our opinion is necessarily based upon market, economic and other conditions as they existed and could be evaluated on, and on the information publicly available to us as of, the date of this opinion. We have no obligation to update this opinion to take into account events occurring after the date that this opinion is delivered to the Independent Board Committee. As a result, circumstances could develop prior to completion of the Proposals that, if known to us at the time we rendered our opinion, would have altered our opinion.

Our opinion is also subject to the following qualifications:

- (i) It is not possible to confirm whether or not the Share Proposal and the Option Proposal are in the interests of each individual Minority Shareholder or Optionholder, respectively, and each Minority Shareholder and Optionholder should consider his/her/its vote on the merits or otherwise of the Share Proposal and the Option Proposal, respectively, in his/her/its own circumstances and from his/her/its own point of view having regard to all the circumstances (and not only the financial perspective offered in this letter) as well as his/her/its own investment objectives;
- (ii) We express no opinion as to whether the Proposals will be completed nor whether they will be successful;
- (iii) Nothing contained in this letter should be construed as us expressing any view as to the trading price or market trends of any securities of CNAC at any particular time; and
- (iv) Nothing contained in this letter should be construed as a recommendation to hold, sell or buy any securities in CNAC.

This letter is for the information of the Independent Board Committee solely in connection with their consideration of the Proposals and, except for its inclusion in this document and for references thereto in the letter from the Independent Board Committee set out in this document, is not to be quoted or referred to, in whole or in part, nor shall this letter be used for any other purpose without our prior written consent.

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CLSA is a licensed securities adviser and corporate finance adviser under the SFO and we, together with our affiliates, provide a full range of investment banking and brokerage services, which, in the course of normal trading activities, may from time to time effect transactions and hold securities, including derivative securities, of CNAC, its subsidiaries or its substantial shareholder (as defined in the Listing Rules) or those of Air China or Cathay for the accounts of customers. CLSA will receive a fee from CNAC for rendering this opinion. CNAC has also agreed to indemnify CLSA and certain related persons against liabilities and expenses in connection with this engagement.

BACKGROUND TO AND MATERIAL TERMS OF THE PROPOSALS

Detailed terms of the Proposals are as set out in the "Letter from the CNAC Board" and the "Explanatory Statement" in this document and the Minority Shareholders and Optionholders are strongly urged to read the entire "Letter from the CNAC Board" and "Explanatory Statement" in this document.

1. The Restructuring Agreement

Reference is made to the Joint Announcement and the Circular pursuant to which it was disclosed that on 8 June 2006, Air China, Cathay, CNAC, CITIC Pacific Limited and Swire Pacific Limited entered into the Restructuring Agreement.

1.1. *Transactions under the Restructuring Agreement*

Pursuant to the Restructuring Agreement, Cathay, *inter alia*, agreed to purchase, and CNAC agreed to sell, 216,447,251 shares in Dragonair ("**Dragonair Shares**") held by the CNAC Group (the "**Disposal**"), representing all of the CNAC Group's 43.29% shareholding in Dragonair, to be satisfied by the issue of 288,596,335 new Cathay shares at an issue price of HK\$13.50 per Cathay share to CNAC and cash consideration of HK\$432,894,497.50. The terms of the restructuring contemplated under the Restructuring Agreement valued 100% of the equity of Dragonair at HK\$10 billion and the CNAC Group's 43.29% shareholding in Dragonair at approximately HK\$4,329 million.

Pursuant to the Restructuring Agreement, Cathay also agreed to purchase the remaining Dragonair Shares from each of Swire Pacific Limited, CITIC Pacific Limited and the Dragonair Minority Shareholders on the same basis and each of Swire Pacific Limited and CITIC Pacific Limited agreed to sell the Dragonair Shares held by each of them.

Pursuant to the extraordinary general meeting of the shareholders of CNAC held on 22 August 2006, the entering into by CNAC of the Restructuring Agreement dated 8 June 2006 between Cathay, Air China, Swire Pacific Limited, CITIC Pacific Limited and CNAC and the implementation of the restructuring contemplated under the Restructuring Agreement, including in particular the disposal by CNAC to Cathay

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of 216,447,251 Dragonair Shares, the acquisition of Cathay shares and the receipt of a cash consideration of HK\$432,894,497.50, was each approved. Further, the transactions contemplated under the Restructuring Agreement were completed on 28 September 2006. As a result, Dragonair has become a wholly-owned subsidiary of Cathay.

1.2. Effect of the completion of the Restructuring Agreement on CNAC

The completion of the restructuring contemplated under the Restructuring Agreement has resulted in CNAC holding a 7.34% minority interest in Cathay, instead of a 43.29% interest in Dragonair. As stated in the "Explanatory Statement" in this document, prior to the completion of the Restructuring Agreement, the CNAC Group was principally engaged in the airline operation business through its 43.29% interest in Dragonair and 51% interest in Air Macau. The 43.29% interest in Dragonair contributed approximately 68.7% and 58.6% of the audited consolidated profit before tax of CNAC for the years ended 31 December 2004 and 31 December 2005, respectively. The interest in Dragonair also contributed to 47.1% and 43.7% of the audited consolidated net assets of CNAC as at 31 December 2004 and 31 December 2005, respectively. CNAC's other principal business, Air Macau, made an audited profit before tax of HK\$54.6 million (net of dividends received from Menzies Macau Airport Services Ltd.), representing approximately 13.4% of the audited consolidated profit before tax of CNAC, for the year ended 31 December 2004 and an audited loss before tax of approximately HK\$45.4 million (net of dividends received from Menzies Macau Airport Services Ltd.) for the year ended 31 December 2005. Accordingly, the interest in Dragonair and, therefore, the airline operation business was, until the Disposal, a substantial part of the CNAC Group's business.

As stated in the Announcement and the Circular, in view of the subsequent material changes in CNAC's business and prospects, it is the view of the CNAC Board that some of the Minority Shareholders may consider whether they should continue to hold their investment in CNAC. As a result, the CNAC Board is of the opinion that the Scheme represents an opportunity for the shareholders to realise their investments in the form of cash proceeds at a premium to the prevailing market price.

As at the Latest Practicable Date, Air China was the registered and beneficial owner of 68.4% of the issued capital of CNAC. As disclosed in the Announcement, implementation of the Restructuring Agreement has resulted in, amongst other things, Air China acquiring a 10.16% shareholding in Cathay and, through CNAC, an indirect interest of 7.34% in Cathay. It is the wish of Air China to rationalize its shareholding in Cathay so that Air China will directly control a 17.5% shareholding in Cathay, thus allowing Air China greater influence over Cathay and to equity account for a higher percentage of Cathay's financial results. Consequently, Air China wishes to privatize CNAC so that CNAC will become a private company within the Air China Group.

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2. The Proposals

2.1. *Terms of the Proposals*

As stated in the “Letter from the CNAC Board” and the “Explanatory Statement” in this document, subject to the Conditions described in the “Explanatory Statement” being fulfilled or waived (as applicable), the privatization proposal will be implemented by way of the Scheme and, to the extent that the outstanding Options have not been exercised so as to result in being the Shares in issue at the Record Time, the cancellation (or lapse) of all of the outstanding Options. The Scheme itself will involve a reduction in the authorized and issued share capital of CNAC by the cancellation of all of the Scheme Shares. Upon the reduction in capital taking effect, the authorized share capital of CNAC will be restored to its former amount by the creation of new Shares, which will be equal to the number of the Scheme Shares cancelled. With the credit arising from the reduction, the new Shares so created will be credited as fully paid and, in accordance with the direction of Air China, issued to Most Known Investments. On the implementation of the Scheme and withdrawal of listing, CNAC will be converted into a private company within the Air China Group.

The Scheme also provides that, in consideration of the cancellation of the Scheme Shares, the holders of the Scheme Shares, being those whose names appear on the share register of CNAC at the Record Time, will be entitled to receive:

HK\$2.80 for every Scheme Share held.

In parallel with but separate from the Scheme, Air China also proposes to make an offer, subject to and conditional upon the Scheme becoming effective, to the holders of all of the outstanding Options to surrender all of such Options to CNAC for cancellation at the price of HK\$1.66, being the see-through price for every such Option. The offer price of HK\$1.66 per Option was arrived at by reference to the difference between the monetary consideration of HK\$2.80 per Scheme Share under the Scheme and the exercise price of HK\$1.14 in respect of each Option. A copy of the letter from Air China to the holders of these Options setting out the terms of the Option Proposal will be despatched on the same day as the despatch of this document.

Further terms of the Proposals, including the procedures for acceptances, are set out in the “Explanatory Statement” in this document.

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2.2. *Conditions of the Scheme*

As stated in the “Letter from the CNAC Board” and the “Explanatory Statement” in this document, the Scheme will become effective and binding on CNAC, Air China and all of the holders of the Scheme Shares, subject to the satisfaction of all, or waiver (as applicable), of the following Conditions:

- (a) the approval of the Scheme by a majority in number representing not less than three-fourths in value of the Shares held by the Minority Shareholders other than those who are acting in concert with Air China that are cast either in person or by proxy at the Court Meeting; and the number of votes cast against the resolution to approve the Scheme is not more than 10% of the votes attached to all of the Shares of all the Minority Shareholders other than those who are acting in concert with Air China;
- (b) the passing of a special resolution to approve and give effect to the Scheme, specifically the reduction of the capital of CNAC by the cancellation of the Scheme Shares, by a majority of at least three-fourths of the votes cast by the shareholders of CNAC present and voting in person or by proxy at the Extraordinary General Meeting by way of a poll;
- (c) the sanction of the Scheme (with or without modifications) by the Court, the compliance with the procedural requirements of Section 58 of the Companies Ordinance in relation to the reduction of the capital of CNAC, the confirmation of the reduction of capital by the Court and the delivery to and registration by the Registrar of Companies of an office copy of the order of the Court, together with a minute containing the particulars required by Section 61 of the Companies Ordinance;
- (d) the receipts from the State Administration for Foreign Exchange of the PRC, the National Development and Reform Commission of the PRC, the Ministry of Commerce of the PRC, the China Civil Aviation Authority of the PRC, the Ministry of Finance of the PRC, the State Assets Supervision and Administration Commission of the PRC, the China Securities Regulatory Commission of the PRC, the China Banking Regulatory Commission of the PRC and the Hong Kong and Macau Affairs Department of the State Council of all relevant authorizations, consents and approvals necessary for the implementation of the privatization proposal, and all such authorizations, consents and approvals remaining in full force and effect;

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- (e) no act referred to under Rule 4 of the Takeovers Code, such as the issue of the Shares or securities convertible into the Shares by CNAC, the sale or disposal or acquisition of assets of a material amount by CNAC or the entry by CNAC into any contracts otherwise than in the ordinary course of the businesses of the CNAC Group, having been or being proposed or threatened to be carried out by the CNAC Board;
- (f) since the date of the Announcement, there having been no force majeure event, including, without limitation, act of God, war, riot, public disorder, civil commotion, economic sanctions, fire, flood, explosion, epidemic, terrorism, labour dispute strike, lock-out, out-break, escalation, declaration or threat of war or hostility, or disaster which is outside Air China's control that would render it impossible for Air China to carry out its obligations under the privatization proposal; and
- (g) save for the payment of a final dividend of HK\$0.01 per Share as approved by the shareholders in the annual general meeting of CNAC held on 25 May 2006 between 21 June 2006 (being the date of the Announcement) and the Effective Date, CNAC not having declared or made or paid any dividend or distribution of any kind, and not having agreed or proposing to declare or make or pay any dividend or distribution of any kind.

Condition (a) is the combined effect of Section 166 of the Companies Ordinance and Rule 2.10 of the Takeovers Code. Insofar as the sanction of the Scheme by the Court is concerned, a resolution for the approval of the Scheme will be deemed to have been passed if a majority in number representing three-fourths in value of the members or class of members, as the case may be, present and voting either in person or by proxy at the meeting or meetings vote in favour of the Scheme. If the Scheme is sanctioned by the Court, it will be binding on all of the shareholders of CNAC, comprising Air China and the Minority Shareholders, and also on CNAC.

Under Rule 2.10 of the Takeovers Code, however, a resolution to approve the Scheme will only be considered to have been passed if (a) the Scheme is approved by at least 75% of the votes attached to the disinterested Shares, being the Shares held by those Minority Shareholders other than those who are acting in concert with Air China, that are cast either in person or by proxy at a duly convened meeting of the holders of the disinterested Shares; and (b) the number of votes cast against the resolution to approve the Scheme at such meeting is not more than 10% of the votes attaching to all of the disinterested Shares.

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As at the Latest Practicable Date, there were 3,312,680,000 Shares in issue of which 1,048,052,000 Shares were held by the Minority Shareholders, representing approximately 31.6% of the issued capital of CNAC. Air China, together with Merrill Lynch PF&S as a party acting in concert with it, was interested in an aggregate of 2,264,642,000 Shares, representing approximately 68.4% of the issued capital of CNAC. Save as disclosed in this paragraph, no other parties acting in concert with Air China were interested in the Shares as at the Latest Practicable Date. Merrill Lynch PF&S, being under the same ultimate control as Merrill Lynch, which is one of the exclusive financial advisers to Air China in relation to the privatization proposal, was the registered and beneficial owner of 14,000 Shares and, as such, is deemed to be a party acting in concert with Air China under the Takeovers Code. Although it is a Minority Shareholder under the Scheme, Merrill Lynch PF&S, together with such other party as may be considered to be acting in concert with Air China, will be required under the Takeovers Code to abstain from voting at the Court Meeting to approve the Scheme and its holding of 14,000 Shares will not be counted as part of the disinterested Shares under Rule 2.10 of the Takeovers Code. In addition, Merrill Lynch International, which is also under the same ultimate control as Merrill Lynch, is the registered and beneficial owner of 4,000 Shares. Notwithstanding that these Shares will form part of the Scheme Shares if they remain so registered at the Record Time, Merrill Lynch International is recognized by the Executive as an exempt principal trader and, under the Takeovers Code, is not deemed to be a party acting in concert with Air China. Although its holding of 4,000 Shares will form part of the Scheme Shares, by virtue of its connection with Air China, Merrill Lynch International is prohibited to vote at the Court Meeting under Rule 35.4 of the Takeovers Code and the 4,000 Shares, similar to those held by Merrill Lynch PF&S, will be excluded from the total number of disinterested Shares when calculating the 10% voting requirement under Rule 2.10 of the Takeovers Code.

Based on 1,048,034,000 Shares held by the Minority Shareholders other than Merrill Lynch PF&S and Merrill Lynch International, and on the assumptions that there will be no other parties acting in concert with Air China becoming holders of the Shares after the Latest Practicable Date and that none of the holders of the outstanding Options will become the holders of any Scheme Shares at the Record Time, 10% of the disinterested Shares would amount to 104,803,400 Shares.

The primary purpose for the convening of the Extraordinary General Meeting for the passing of the special resolution as mentioned in Condition (b) above is to satisfy the requirements laid down in Section 58 of the Companies Ordinance for the reduction of the capital of CNAC so as to give effect to the Scheme. Such statutory requirements cannot be overridden or subject to any regulations, including the Listing Rules or the Takeovers Code. Accordingly, all holders of the Shares, including Air China and parties acting in concert or connected with Air China, are entitled under the articles of association of CNAC to attend and vote at the Extraordinary General Meeting. As stated by the CNAC Board in the "Explanatory Statement", if the Scheme

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is approved at the Court Meeting, it is the intention of Merrill Lynch PF&S and Merrill Lynch International to voluntarily abstain from voting at the Extraordinary General Meeting. As stated in the “Explanatory Statement”, Air China will attend and vote in favor of the special resolution to be proposed at the Extraordinary General Meeting.

The Minority Shareholders, however, should note that since the Scheme will only become effective and binding on CNAC, the Minority Shareholders and Air China if all of the Conditions are met, in effect the Scheme will not become effective even if Sections 166 and 58 of the Companies Ordinance are complied with unless the requirements under Rule 2.10 of the Takeovers Code have also been fulfilled.

Air China will use its reasonable endeavours to fulfill the Conditions which are within its powers to do so in a timely manner. Air China also reserves the right, at its absolute discretion, to waive, in whole or in part, any of the Conditions referred to in paragraphs (e) to (g) above. Conditions (a) to (d) cannot be waived by Air China. **In the event that any of Conditions (a) to (c) is not satisfied on or before 10 April 2007, or such later date as the Court may approve in relation to the Scheme, the Scheme will lapse.** Except for any acceptance condition which has no application to the privatization proposal, Air China will not invoke any condition, including any of the Conditions, as a basis for not proceeding with the Scheme as imposed by Note 2 to Rule 30.1 of the Takeovers Code unless the circumstances which give rise to the right to invoke the condition are of material significance to Air China in the context of the Scheme. There was no agreement or arrangement as at the Latest Practicable Date to which Air China was a party which related to the circumstances in which Air China might or might not invoke or seek to invoke a condition to the privatization proposal.

As stated in the “Letter from the CNAC Board” in this document, the Minority Shareholders should be aware that the implementation of the proposal to privatize CNAC is subject to the Conditions being fulfilled or waived (as applicable) and, accordingly, may or may not become effective. Therefore, in the meantime, the Minority Shareholders are reminded to exercise caution when dealing in the Shares.

2.3. *Other Issues*

As at the Latest Practicable Date, there were 104,378,000 outstanding Options, which were held by Messrs. Zhang Xianlin, Gu Tiefei, Chuang Shih Ping and Tsang Hing Kwong, Thomas, all being executive directors of CNAC. Each of Messrs. Zhang Xianlin and Gu Tiefei, holding respectively 33,126,000 and 5,000,000 Options, has undertaken to CNAC and Air China that he would neither accept any of Air China’s proposed offer to acquire his outstanding Options for cancellation nor would he exercise any of his Options before their expiry. Each of Messrs. Chuang Shih Ping and Tsang Hing Kwong, Thomas, together holding a total of 66,252,000 Options, has also irrevocably undertaken to CNAC and Air China that to the extent that any of

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his Options remain unexercised on the day of the hearing of the petition for the sanction of the Scheme by the Court, subject to the Scheme becoming effective, he would not exercise any of such Options as from that day and would accept the proposal by Air China for their cancellation in accordance with the terms set out in the letter to the Optionholders from Air China provided that the consideration for the cancellation should be HK\$1.66 per Option. If either of these parties has exercised any of his Options so as to become entitled to attend and vote at the Court Meeting, Mr. Chuang Shih Ping has indicated that he would vote in favour of the resolution for the approval of the Scheme and Mr. Tsang Hing Kwong, Thomas has indicated that he would voluntarily abstain from voting on the same resolution.

PRINCIPAL FACTORS CONSIDERED

In considering whether or not the terms and conditions of the Proposals are fair and reasonable and in the interests of the Minority Shareholders and Optionholders as a whole, we have taken into consideration, *inter alia*, the following factors:

1. The Proposals

1.1. *The Share Proposal and the Option Proposal*

As stated in the "Letter from the CNAC Board" in this document, Air China will make the Proposals on the following basis:

HK\$2.80 for every Scheme Share held.

HK\$1.66for every outstanding Option cancelled.

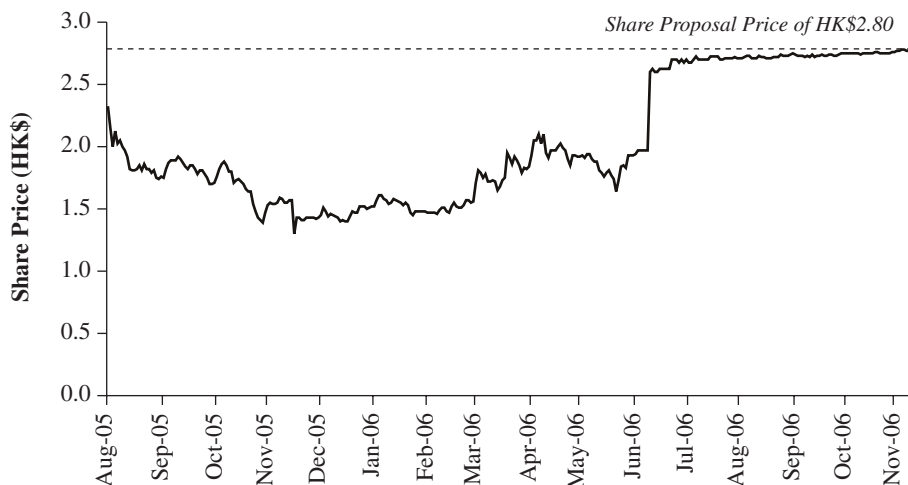
In accordance with the terms of the share option scheme adopted by CNAC on 29 May 2002, the holders of the Options are entitled to exercise their Options to subscribe for the Shares at a price of HK\$1.14 per Share. Any Shares issued before the Record Time upon exercise of the Options in accordance with the terms of the share option scheme will form part of the Scheme Shares.

If Optionholders do not exercise their Options, the Option Proposal offers the Optionholders the opportunity, in respect of each outstanding Option, to receive a payment of HK\$1.66, in cash, which is equal to the cash payment an Optionholder will receive if he has exercised his outstanding Options and accepted the Share Proposal in respect of those Shares he has received as a result of such exercise. The Option Proposal Price represents a see-through price of HK\$1.66 per outstanding Option. Further information on the Option Proposal can be found in the letter from Air China to the Optionholders which will be despatched on the same day as the despatch of this document.

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1.2. Historical Share Price Performance of CNAC and Premium Represented

The following chart sets out the daily historical closing prices of the Shares traded on the Stock Exchange during 1 August 2005 and 13 November 2006 (the "Review Period").



In assessing the fairness and reasonableness of the Share Proposal Price and the Option Proposal, we have reviewed the premium represented by the Share Proposal Price to CNAC's historical share price performance.

The table below states the closing price of the Shares as at 13 November 2006, being the Last Practicable Date, as at 2 June 2006, being the Last Trading Date on which the Shares were traded prior to the publication of the Joint Announcement, the average closing price for the 10, 30, 60 and 180 trading-

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day period prior to and including the Last Trading Date, and the premium which the Share Proposal Price represents over such closing prices:

Date/ Corresponding Period	Closing price/ average closing price (HK\$)	Approximate premium of the Share Proposal Price to the closing price/average closing price (%)
13 November 2006 – Last Practicable Date	2.76	1.4
Last Trading Date	1.97	42.1
5 trading-day period prior to the Last Trading Date	1.94	44.3
10 trading-day period prior to the Last Trading Date	1.86	50.6
30 trading-day period prior to the Last Trading Date	1.86	50.3
60 trading-day period prior to the Last Trading Date	1.88	48.6
180 trading-day period prior to the Last Trading Date	1.66	68.2

Source: Bloomberg

As shown in the table above, the premiums represented by the Share Proposal Price to the closing price as at the Last Trading Date and the average closing price for the respective periods prior to and including the Last Trading Date range from 42.1% to approximately 68.2%.

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1.3. Precedent Privatization Premiums

We have identified from publicly available sources¹ all completed privatization transactions, to the best of our knowledge, announced since 1 January 2003 up to and including 21 June 2006, being the date of the joint announcement by Air China and CNAC on the privatisation proposal, for companies listed on the main board of the Stock Exchange. We have reviewed the available information for such transactions as summarised below (the “**Precedent Transactions**”):

Company	Date of Announcement	Cancellation Price (HK\$)	Last Full Trading Day ¹ (HK\$)	Premium to closing share price/average closing share price (%)				NAV ¹ (HK\$)	Cancellation Price Premium/Discount to NAV per Share (%)
				Last Full Trading Day	Last 5-day Trading Price	Last 10-day Trading Price	Last 30-day Trading Price		
Asia Aluminum Holdings Ltd	16 Mar 2006	1.45	1.15	26.1%	31.3%	36.3%	49.7%	0.92	58.0%
Sinopec Zhenhai Refining & Chemical Co Ltd	12 Nov 2005	10.60	9.45	12.2%	17.5%	20.2%	24.8%	4.24	150.0%
New World TMT Ltd	2 Nov 2005	0.75	0.42	78.6%	79.9%	76.1%	70.1%	0.75	0.3%
Jilin Chemical Industrial Co Ltd	28 Oct 2005	2.80	2.43	15.5%	14.8%	18.1%	17.3%	1.33	110.0%
China Resources Peoples Telephone Co Ltd	4 Oct 2005	4.55	3.90	16.7%	25.5%	33.8%	54.1%	1.23	269.3%
Henderson China Holdings Ltd	19 May 2005	8.00	4.80	66.7%	61.6%	61.1%	64.3%	13.97	-42.7%
HGC Holdings Ltd	3 May 2005	0.65	0.48	36.8%	45.1%	44.0%	43.8%	0.03	NM
Sinopec Beijing Yanhua Petrochemical Co Ltd	29 Dec 2004	3.80	3.43	10.9%	15.9%	18.8%	23.9%	1.53	147.9%
Kwong Sang Hong International Ltd	4 Nov 2004	1.25	1.19	5.0%	13.8%	23.0%	36.2%	1.34	-6.5%
Elec & Eltek International Holdings Ltd	13 Oct 2004	1.90	1.74	9.2%	9.1%	13.0%	27.6%	0.64	195.5%
Alpha General (Holdings) Ltd	13 Oct 2004	0.70	0.31	125.8%	134.9%	134.1%	134.2%	1.33	-47.4%
Harbin Brewery Group Ltd	1 Jun 2004	5.58	5.10	9.4%	10.8%	13.1%	32.5%	1.05	433.7%
Chevalier Construction Holdings Ltd	31 Oct 2003	0.25	0.22	16.3%	16.3%	16.5%	23.9%	0.31	-18.5%
Pacific Concord Holding Ltd	26 May 2003	0.65	0.43	51.2%	55.1%	61.3%	60.8%	2.19	-70.3%
Oxford Properties & Finance Ltd	21 May 2003	15.00	8.90	68.5%	68.9%	68.7%	71.2%	14.03	6.9%
Top Glory International Holdings Ltd	3 May 2003	0.74	0.40	85.0%	83.2%	81.2%	73.7%	1.44	-48.7%
Precedent Transactions Average				39.6%	42.7%	45.0%	50.5%		75.8%
Precedent Transactions Median				21.4%	28.4%	35.1%	46.7%		6.9%
CNAC Share Proposal		2.80	1.97	42.1%	44.3%	50.6%	50.3%	1.83	53.2%

Sources: Thomson One Banker, Bloomberg and respective company circulars and announcements.
 NM: Not meaningful

¹ Sources: Stock Exchange website, Bloomberg and respective company circulars and announcements.

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Notes:

1. Closing share price of Precedent Transactions as at the respective last full trading day prior to the issue of a privatization announcement by the respective companies (the “**Last Full Trading Day**”) (in the case of CNAC, being the Last Trading Date).
2. Net asset value (“**NAV**”) from published financial information contained in the latest annual reports of the respective companies available prior to the respective privatization announcements and adjusted for any dividends paid between the date of the financial year end of the respective annual reports and the date of the respective privatization announcement. The NAV of CNAC is based on its unaudited pro forma consolidated balance sheet as at 31 December 2005 and adjusted for dividends of HK\$33.1 million.

In assessing the fairness of the Share Proposal Price and the Option Proposal Price, we have compared first, the premiums represented by the Share Proposal Price over the average closing price of the Shares at various periods with the respective premiums represented by the average cancellation prices offered by the Precedent Transactions; and secondly, the premium of the Share Proposal Price over the NAV per Share with the average NAV premium per share offered in the Precedent Transactions. Given the wide range in premiums of the Precedent Transactions, in particular the wide range of NAV discounts or premiums per share as represented by the cancellation prices of the Precedent Transactions, we have also compared the premiums represented by the Share Proposal Price with the median premiums of the Precedent Transactions.

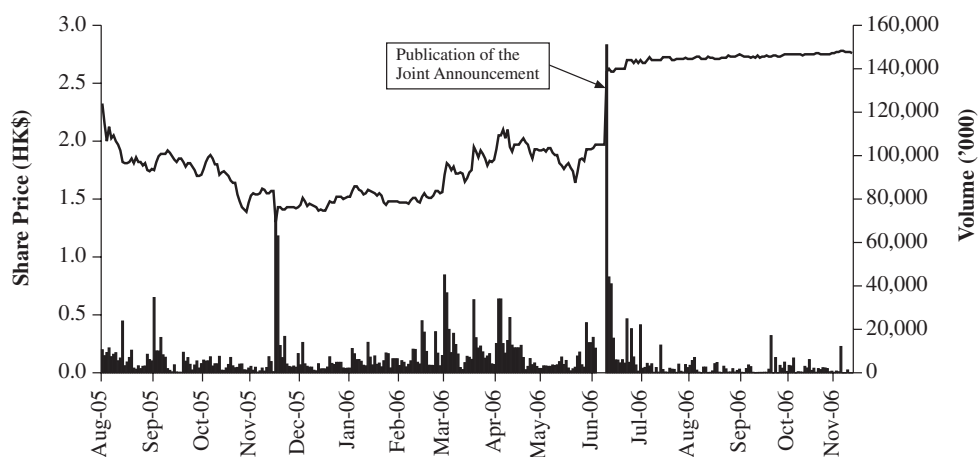
As shown in the table above, the premiums represented by the Share Proposal Price over the average closing price of the Shares at various periods are above the premiums represented by the average cancellation prices offered by the Precedent Transactions, except for the premium to the average 30-day trading price. The premium represented by the Share Proposal Price over the average closing price of the Shares on the Last Trading Date, as well as over the average closing prices at various periods prior to the Last Trading Date, are all above the median premiums represented by the cancellation prices offered by the Precedent Transactions and is within the range of cancellation price premiums of 5.0% to 134.9% represented by the Precedent Transactions.

The premium as represented by the Share Proposal Price over the NAV per Share, after adjusting for dividends, is lower than the average NAV premium per share offered in the Precedent Transactions. However, the NAV premium as represented by the Share Proposal Price is significantly higher than the median NAV premium of the Precedent Transactions and is within the range of NAV discounts/premiums of -70.3% to 433.7% represented by the Precedent Transactions.

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1.4. Potential Impact on Trading Liquidity and Trading Price

The following chart sets out the daily historical closing prices and trading volumes of the Shares traded on the Stock Exchange during the Review Period:



Source: Bloomberg

The average and month-end daily closing prices and the average and total traded volume of the Shares for each of the months during the Review Period were as follows:

	Average daily closing price (HK\$)	Month/ period-end closing price (HK\$)	Average daily volume (‘000)	Total volume (‘000)
2005				
August	1.91	1.76	6,963	160,149
September	1.82	1.71	6,172	135,790
October	1.67	1.47	3,725	78,226
November	1.49	1.43	10,118	222,600
December	1.46	1.52	3,611	79,435
2006				
January	1.53	1.48	6,089	133,949
February	1.51	1.56	7,864	157,277
March	1.79	1.84	12,763	293,553
April	1.98	1.92	11,708	234,164
May	1.85	1.93	5,538	127,364
June	2.46	2.70	21,630	389,342
July	2.71	2.71	2,359	49,546
August	2.72	2.75	1,865	42,894
September	2.73	2.75	2,192	46,026
October	2.75	2.76	1,963	39,252
November	2.77	n.a.	1,656	n.a.

Source: Bloomberg

Note: n.a.= not applicable

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The trading volume significantly increased following the publication of the Joint Announcement on 8 June 2006, but has since significantly decreased below the average daily volume for the last 12 months prior to the publication of the Joint Announcement. The trading price also increased following the publication of the Joint Announcement on 8 June 2006 and has remained at a higher level up to the Latest Practicable Date. There is no assurance that the trading price of CNAC shares will remain at current levels if the Scheme does not proceed to completion.

The Minority Shareholders should note that the past trading performance of the Shares should not in any way be relied upon as an indication of its future trading performance. If the Scheme is not successful, the trading price of the Shares may revert to their historical trading range before the Joint Announcement, which may be below the Share Proposal Price. As such, the Proposals offer the Minority Shareholders and the Optionholders an opportunity to realise their investment in CNAC at the Share Proposal Price and the Option Proposal Price, respectively.

1.5. Other Considerations

As stated by the CNAC Board in the “Explanatory Statement” in this document, the completion of the Restructuring Agreement has resulted in CNAC no longer holding any interest in Dragonair. In turn, CNAC now holds a 7.34% direct equity interest in Cathay, but without any representation on the board of Cathay. Accordingly, the CNAC Board believes that the disposal of the 43.29% interest in Dragonair has effectively turned CNAC into a passive investment holding company with a 7.34% minority interest in Cathay.

Further, based on the unaudited pro forma consolidated income statement of the CNAC Group for the year ended 31 December 2005 included in the Circular, the unaudited pro forma profit attributable to the shareholders of CNAC would have increased from approximately HK\$225 million to HK\$3,569 million had the sale of CNAC Group’s entire interest in Dragonair and the acquisition of the shares in Cathay been completed on 1 January 2005. In addition, based on the unaudited pro forma consolidated balance sheet of the CNAC Group for the year ended 31 December 2005 included in the Circular, the unaudited pro forma net assets of the CNAC Group would have increased from approximately HK\$3,126 million (approximately HK\$0.944 per Share) to HK\$6,086 million (approximately HK\$1.837 per Share) had the sale of CNAC Group’s entire interest in Dragonair and the acquisition of the shares in Cathay been completed on 31 December 2005. As stated by the CNAC Board in the “Explanatory Statement”, such pro forma increase in profit and net asset, however, is an isolated event derived from the disposal of CNAC’s interest in Dragonair. Although the CNAC Group continues its airline operation business after the completion of the Restructuring Agreement through its 51% interest in Air Macau, as stated by the CNAC Board in the “Explanatory Statement” in

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this document, that business has shrunk substantially in terms of revenue and net income attributable primarily to the disposal of the substantial interest in Dragonair. The remaining businesses of the CNAC Group, which now constitute its major businesses, mainly comprise air catering services, airport ground handling services and logistics services in Hong Kong. Therefore, the CNAC Board believes that the Minority Shareholders may perceive the CNAC Group's business focus to have shifted more to aviation services than airline operation after the completion of the Restructuring Agreement.

As stated in the "Explanatory Statement" in this document, Air China has no current intention to introduce any major change to the existing operating and management structures of CNAC irrespective of whether or not the Scheme becomes effective.

In addition, as stated in the "Explanatory Statement" in this document, Air China has no present intention whatsoever to divest any of its shareholdings in CNAC. As approximately 68.4% of CNAC is held by Air China, the CNAC Board believes that it is unlikely that the Minority Shareholders will receive any other offer from a third party to acquire their Shares if the Scheme does not become effective.

CONCLUSION AND OPINION

In reaching our opinion (on the basis set out at the beginning of this letter), we have considered the above principal factors and reasons and, in particular, have taken into account the following in arriving at our opinion:

- the Share Proposal Price represents a premium of between 42.1% and 68.2% over the closing price of the Shares as at the Last Trading Date and the average closing prices for 10, 30, 60 and 180 days prior to and including the Last Trading Date;
- the Share Proposal Price represents a premium of 42.1%, 44.3%, 50.6% and 50.3% over the respective closing price of the Shares as at the Last Trading Date, the average last 5-day, 10-day and 30-day trading price, which is above each of the respective average closing share price premium over the Last Trading Date, the average last 5-day and 10-day trading price of the Precedent Transactions, and which is all above the respective median closing share price premiums of the Precedent Transactions;
- the Share Proposal Price represents a premium of approximately 53.2% over the NAV per Share compared to the median NAV premium per share of 6.9% for Precedent Transactions and is within the range of NAV premiums of the Precedent Transactions;

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- the Option Proposal Price represents cash equal to the cash payment which Optionholders would receive if they had exercised their outstanding Options and accepted the Share Proposal in respect of those Shares arising as a result of such exercise; and
- the Proposals offer the Minority Shareholders and the Optionholders an opportunity to realise their investment following the material changes to CNAC's business and prospects as a result of the completion of the Restructuring Agreement.

Having considered the above, we are of the opinion that the terms and conditions of the Proposals, in particular the Share Proposal Price and the Option Proposal Price, are fair and reasonable so far as the Minority Shareholders and the Optionholders, respectively, are concerned. Accordingly, we advise the Independent Board Committee to recommend to the Minority Shareholders to approve the Scheme at the Court Meeting and to vote in favour of the special resolution to approve and give effect to the Scheme at the Extraordinary General Meeting to be convened on 15 December 2006 and recommend to the Optionholders to accept the Option Proposal for any Options outstanding as at the day of the hearing of the petition for the sanction of the Scheme by the Court.

Yours faithfully,
For and on behalf of
CLSA Equity Capital Markets Limited
Robert Reid
Managing Director

EXPLANATORY STATEMENT

This Explanatory Statement constitutes the statement required under Section 166A of the Companies Ordinance.

SCHEME OF ARRANGEMENT

INTRODUCTION

As jointly announced by CNAC and Air China on 21 June 2006, subject to the completion of the transactions contemplated under the Restructuring Agreement, Air China, which is a majority shareholder of CNAC, would make a proposal to privatize CNAC by way of a scheme of arrangement under Section 166 of the Companies Ordinance whereby CNAC will become a private company within the Air China Group. The transactions contemplated under the Restructuring Agreement were completed on 28 September 2006.

The purpose of this Explanatory Statement is to explain the conditions and the effects of the Scheme and to give the Minority Shareholders other relevant information.

BACKGROUND TO THE PROPOSAL

Under the terms of the Restructuring Agreement, CNAC was obliged to dispose of its 43.29% interest in Dragonair to Cathay in return for a 7.34% interest in Cathay and a cash consideration of approximately HK\$433 million. Under the Listing Rules, the transaction was contingent upon, amongst other things, its approval by the independent shareholders of CNAC by way of an ordinary resolution. With a view to seeking support for the passing of the resolution, an irrevocable undertaking to vote in favour of the transaction was extracted by both CNAC and Air China from On Ling Investments Limited, which beneficially owns approximately 9.75% of the issued capital of CNAC. The undertaking, however, was conditional upon

- (a) the publication of an announcement by or on behalf of Air China of an offer in cash for all of the issued Shares other than those owned by Air China and parties acting in concert with Air China, on terms no less favourable than HK\$2.80 per Share; and
- (b) the independent financial adviser appointed by an independent committee of the CNAC Board being of the opinion that the terms of the disposal of CNAC's shareholding in Dragonair and the acquisition by CNAC of the shares in Cathay as well as Air China's offer from a financial perspective were fair and reasonable.

The condition set out in paragraph (a) above was satisfied on 21 June 2006 when the Announcement was made. In relation to the condition described in paragraph (b) above, CLSA, as the then independent financial adviser, published, in the circular issued by CNAC on 30 June 2006 convening the meeting of the independent shareholders for the sanction of the transaction, its opinion that the Restructuring Agreement and, more particularly, the disposal by CNAC of its entire holding of Dragonair shares and its acquisition of the shares in Cathay were fair and reasonable and that the proposed price of HK\$2.80 per Share by Air China was, from a financial perspective, also fair and reasonable. The latter opinion of CLSA is affirmed in the "Letter from CLSA" appearing on pages 13 to 31 of this document which contains a fuller analysis of the terms of the privatization proposal.

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The ordinary resolution for the approval of the performance of CNAC's contractual obligations under the Restructuring Agreement as required by the Listing Rules was passed by its independent shareholders at the extraordinary general meeting of CNAC held on 22 August 2006. As mentioned above, all the transactions embodied in the Restructuring Agreement were completed on 28 September 2006. The CNAC Board, having considered carefully the merits of the privatization proposal and was of the opinion that it would be in the interests of CNAC and its shareholders as a whole, now puts forward the privatization proposal.

SUMMARY OF THE PROPOSAL

In addition to providing to the Minority Shareholders with further information regarding the proposal for the privatization of CNAC, the purpose of the document of which this Explanatory Statement forms part is to give to the Minority Shareholders notices of the Court Meeting and the Extraordinary General Meeting. Apart from this Explanatory Statement, the Minority Shareholders' attention is also drawn to the letter from the Independent Board Committee, the letter from CLSA and the Scheme set out in this document.

As at the Latest Practicable Date, there were 3,312,680,000 Shares in issue and 104,378,000 Options which remained outstanding. Apart from these, there were no other outstanding options, warrants, derivatives or other forms of securities issued by CNAC carrying a right to subscribe for or which would be convertible into the Shares.

Subject to the Conditions being fulfilled or waived (as applicable), the privatization will be implemented by way of the Scheme and the cancellation of all of the outstanding Options. The Scheme involves a reduction in the authorized and issued share capital of CNAC by the cancellation of all of the Scheme Shares. Upon the reduction of capital taking effect, the authorized capital of CNAC will be restored to its former amount by the creation of new Shares, which will be equal to the number of the Scheme Shares cancelled. With the credit arising from the reduction, the new Shares so created will be credited as fully paid and issued to Air China or such other parties as it may direct. Air China has directed CNAC that, in the event of the Scheme becoming effective, such new Shares should be issued to Most Known Investments. On the implementation of the Scheme, CNAC will become a private company within the Air China Group.

Most Known Investments is a wholly-owned subsidiary of Total Transform Group Limited, which is 99.9% directly owned by Air China and 0.1% owned by Air China Development Corporation (H.K.) Limited. Air China Development Corporation (H.K.) Limited is in turn a 95% owned subsidiary of Air China and the remaining 5% interest is indirectly owned by the controlling shareholder of Air China, China National Aviation Holding Company, which is a company incorporated in the PRC. None of the new Shares to be issued to Most Known Investments pursuant to the Scheme will be transferred, charged or pledged to any other persons and there are no agreements, arrangements or understandings to do the same, nor are there any related charges or pledges which may result in the transfer by Most Known Investments of the voting rights attached to the new Shares.

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The Scheme also provides that, in consideration of the cancellation of the Scheme Shares, their holders, being those whose names appear on the share register of CNAC at the Record Time, will be entitled to receive:

HK\$2.80 for every Scheme Share held.

The monetary consideration of HK\$2.80 per Scheme Share to which the holders of the Scheme Shares are entitled will be paid in full without regard to any lien, right of set-off, counterclaim or other analogous right to which Air China or CNAC may otherwise be, or claim to be, entitled against such holders.

In parallel with but separate from the Scheme, Air China also proposes to make an offer, subject to and conditional upon the Scheme becoming effective, to the holders of all of the outstanding Options to surrender all of such Options to CNAC for cancellation at the price of HK\$1.66 for every such Option. The offer price of HK\$1.66 per Option was arrived at by reference to the difference between the monetary consideration of HK\$2.80 per Scheme Share under the Scheme and the exercise price of HK\$1.14 in respect of each Option. A copy of a letter from Air China to the holders of these Options setting out the terms of the proposal will be despatched on the same day as the despatch of this document.

As at the Latest Practicable Date, there were 104,378,000 outstanding Options which were held by Messrs. Zhang Xianlin, Gu Tiefei, Chuang Shih Ping and Tsang Hing Kwong, Thomas, all being executive directors of CNAC. Each of Messrs. Zhang Xianlin and Gu Tiefei, holding respectively 33,126,000 and 5,000,000 Options, has undertaken to CNAC and Air China that he would neither accept any of Air China's proposed offer for cancellation of his outstanding Options nor exercise any of his Options before their expiry date. Each of Messrs. Chuang Shih Ping and Tsang Hing Kwong, Thomas, holding 33,126,000 and 33,126,000 Options respectively, has also irrevocably undertaken to CNAC and Air China that if any of his Options remained unexercised on the day of the hearing of the petition to sanction the Scheme by the Court, subject to the Scheme becoming effective, he would not exercise any of the Options as from the Record Time and would accept the proposal by Air China for the cancellation of such Options on condition that the consideration for the cancellation of each Option should be HK\$1.66. If either of these directors has exercised the Options thereby becoming entitled to attend and vote at the Court Meeting, Mr. Chuang Shih Ping has indicated that he would vote in favour of the resolution for the approval of the Scheme and Mr. Tsang Hing Kwong, Thomas has indicated that he would voluntarily abstain from voting on the same resolution.

On the basis that the 1,048,052,000 Shares held by the Minority Shareholders as at the Latest Practicable Date will become the Scheme Shares and that the cancellation price is HK\$2.80 per Scheme Share, the Scheme Shares are valued at approximately HK\$2,934.5 million.

There were 104,378,000 Options outstanding as at the Latest Practicable Date. Assuming that none of these Options will be exercised prior to the day when the Scheme is sanctioned by the Court, the consideration of HK\$1.66 per Option payable for their cancellation, disregarding for this purpose the above undertakings of Messrs. Zhang Xianlin and Gu Tiefei, will amount to HK\$173.3 million.

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If, however, all of the outstanding Options will be exercised in full thereby resulting in Scheme Shares at the Record Time, the consideration for the cancellation of the Scheme Shares pursuant to the Scheme will be increased to approximately HK\$3,226.8 million.

Air China intends to fund the cash required to effect the Scheme and the cancellation of the outstanding Options from bank borrowings in the PRC. CICC and Merrill Lynch, the exclusive financial advisers to Air China in respect of the privatization, are satisfied that sufficient financial resources are available to Air China for the implementation of the Scheme and the offer in respect of the cancellation of the outstanding Options. Air China does not intend that the payment of interest on, repayment of or security for the bank borrowings will depend to any significant extent on the businesses of the CNAC Group.

The Scheme, the costs of which will be borne by CNAC, will become effective and binding on CNAC and all of the holders of the Scheme Shares, subject to the satisfaction of all, or waiver if applicable, of the Conditions. The Conditions are set out in the following section headed "Conditions of the Scheme".

The Scheme will lapse if it is withdrawn or does not become effective on or before 10 April 2007, or such later date as the Court may allow. In such event, the Minority Shareholders will be notified by way of a press announcement.

Assuming that the Scheme becomes effective on 10 January 2007, cheques for the payment of the monetary entitlements under the Scheme will be despatched to the holders of the Scheme Shares on or before 20 January 2007.

CONDITIONS OF THE SCHEME

The Scheme will become effective and binding on CNAC, Air China and all of the holders of the Scheme Shares, subject to the satisfaction or waiver, if applicable, of the following Conditions:

- (a) the approval of the Scheme by a majority in number representing not less than three-fourths in value of the Shares held by the Minority Shareholders other than those who are acting in concert with Air China that are cast either in person or by proxy at the Court Meeting; and the number of votes cast against the resolution to approve the Scheme is not more than 10% of the votes attached to all of the Shares of all the Minority Shareholders other than those who are acting in concert with Air China;
- (b) the passing of a special resolution to approve and give effect to the Scheme, specifically the reduction of the capital of CNAC by the cancellation of the Scheme Shares, by a majority of at least three-fourths of the votes cast by the shareholders of CNAC present and voting in person or by proxy at the Extraordinary General Meeting by way of a poll;

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- (c) the sanction of the Scheme (with or without modifications) by the Court, the compliance with the procedural requirements of Section 58 of the Companies Ordinance in relation to the reduction of the capital of CNAC, the confirmation of the reduction of capital by the Court and the delivery to and registration by the Registrar of Companies of an office copy of the order of the Court, together with a minute containing the particulars required by Section 61 of the Companies Ordinance;
- (d) the receipts from the State Administration for Foreign Exchange of the PRC, the National Development and Reform Commission of the PRC, the Ministry of Commerce of the PRC, the China Civil Aviation Authority of the PRC, the Ministry of Finance of the PRC, the State Assets Supervision and Administration Commission of the PRC, the China Securities Regulatory Commission of the PRC, the China Banking Regulatory Commission of the PRC and the Hong Kong and Macau Affairs Department of the State Council of all relevant authorizations, consents and approvals necessary for the implementation of the privatization proposal, and all such authorizations, consents and approvals remaining in full force and effect;
- (e) no act referred to under Rule 4 of the Takeovers Code, such as the issue of the Shares or securities convertible into the Shares by CNAC, the sale or disposal or acquisition of assets of a material amount by CNAC or the entry by CNAC into any contracts otherwise than in the ordinary course of the businesses of the CNAC Group, having been or being proposed or threatened to be carried out by the CNAC Board;
- (f) since the date of the Announcement, there having been no force majeure event, including, without limitation, act of God, war, riot, public disorder, civil commotion, economic sanctions, fire, flood, explosion, epidemic, terrorism, labour dispute strike, lock-out, out-break, escalation, declaration or threat of war or hostility, or disaster which is outside Air China's control that would render it impossible for Air China to carry out its obligations under the privatization proposal; and
- (g) save for the payment of a final dividend of HK\$0.01 per Share as approved by the shareholders in the annual general meeting of CNAC held on 25 May 2006 between 21 June 2006 (being the date of the Announcement) and the Effective Date, CNAC not having declared or made or paid any dividend or distribution of any kind, and not having agreed or proposing to declare or make or pay any dividend or distribution of any kind.

Condition (a) is the combined effect of Section 166 of the Companies Ordinance and Rule 2.10 of the Takeovers Code. Insofar as the sanction of the Scheme by the Court is concerned, a resolution for the approval of the Scheme will be deemed to have been passed if a majority in number representing three-fourths in value of the members or class of members, as the case may be, present and voting either in person or by proxy at the meeting or meetings vote in favour of the Scheme. If the Scheme is sanctioned by the Court, it will be binding on all of the shareholders of CNAC, comprising Air China and the Minority Shareholders, and also on CNAC.

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Under Rule 2.10 of the Takeovers Code, however, a resolution to approve the Scheme will only be considered to have been passed if (a) the Scheme is approved by at least 75% of the votes attached to the disinterested Shares, being the Shares held by those Minority Shareholders other than those who are acting in concert with Air China, that are cast either in person or by proxy at a duly convened meeting of the holders of the disinterested Shares; and (b) the number of votes cast against the resolution to approve the Scheme at such meeting is not more than 10% of the votes attaching to all of the disinterested Shares.

As at the Latest Practicable Date, there were 1,048,052,000 Shares held by the Minority Shareholders, representing 31.6% of the issued capital of CNAC. Merrill Lynch PF&S, being under the same ultimate control as Merrill Lynch, which is one of the exclusive financial advisers to Air China in relation to the privatization proposal, was the registered and beneficial owner of 14,000 Shares and, as such, is deemed to be a party acting in concert with Air China under the Takeovers Code. Although it is a Minority Shareholder under the Scheme, Merrill Lynch PF&S, together with such other party as may be considered to be acting in concert with Air China, will be required under the Takeovers Code to abstain from voting at the Court Meeting to approve the Scheme and its holding of 14,000 Shares will not be counted as part of the disinterested Shares under Rule 2.10 of the Takeovers Code. In addition, Merrill Lynch International, which is also under the same ultimate control as Merrill Lynch, is the registered and beneficial owner of 4,000 Shares. Notwithstanding that these Shares will form part of the Scheme Shares if they remain so registered at the Record Time, Merrill Lynch International is recognized by the Executive as an exempt principal trader and, under the Takeovers Code, is not deemed to be a party acting in concert with Air China. Although its holding of the 4,000 Shares will form part of the Scheme Shares, by virtue of its connection with Air China, Merrill Lynch International is prohibited to vote at the Court Meeting under Rule 35.4 of the Takeovers Code and the 4,000 Shares, similar to those held by Merrill Lynch PF&S, will be excluded from the total number of the disinterested Shares when calculating the 10% voting requirement under Rule 2.10 of the Takeovers Code.

In the circumstances, based on the 1,048,034,000 Shares held by the Minority Shareholders other than Merrill Lynch PF&S and Merrill Lynch International, and on the assumptions that there will be no other parties acting in concert with Air China becoming holders of the Shares after the Latest Practicable Date and that none of the holders of the outstanding Options will become the holders of any Scheme Shares at the Record Time, 10% of the disinterested Shares would amount to 104,803,400 Shares.

The Court Meeting is convened at the Court's direction for the specific purpose of approving the Scheme as prescribed by Section 166 of the Companies Ordinance and is therefore different from a shareholders' meeting of CNAC which must be convened and held in accordance with CNAC's articles of association.

The primary purpose for the convening of the Extraordinary General Meeting for the passing of the special resolution as mentioned in Condition (b) above is to satisfy the requirements laid down in Section 58 of the Companies Ordinance for the reduction of the capital of CNAC so as to give effect to the Scheme. Such statutory requirements cannot be overridden or subject to any regulations, including the Listing Rules or the Takeovers

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Code. Accordingly, all holders of the Shares, including Air China and parties acting in concert or connected with Air China, are entitled under the articles of association of CNAC to attend and vote at the Extraordinary General Meeting. If the Scheme is approved at the Court Meeting, it is the intention of Merrill Lynch PF&S and Merrill Lynch International to voluntarily abstain from voting at the Extraordinary General Meeting. Air China will attend and vote in favour of the special resolution to be proposed at the Extraordinary General Meeting.

The Minority Shareholders, however, should note that since the Scheme will only become effective and binding on CNAC, the Minority Shareholders and Air China if all of the Conditions are met, in effect the Scheme will not become effective even if Sections 166 and 58 of the Companies Ordinance are complied with unless the requirements under Rule 2.10 of the Takeovers Code have also been fulfilled.

Air China will use its reasonable endeavours to fulfill the Conditions which are within its powers to do so in a timely manner. Air China also reserves the right, at its absolute discretion, to waive, in whole or in part, any of the Conditions referred to in paragraphs (e) to (g) above. Conditions (a) to (d) cannot be waived by Air China. **In the event that any of Conditions (a) to (c) is not satisfied on or before 10 April 2007, or such later date as the Court may approve in relation to the Scheme, the Scheme will lapse.** Except for any acceptance condition which has no application to the privatization proposal, Air China will not invoke any condition, including any of the Conditions, as a basis for not proceeding with the Scheme as imposed by Note 2 to Rule 30.1 of the Takeovers Code unless the circumstances which give rise to the right to invoke the condition are of material significance to Air China in the context of the Scheme. There was no agreement or arrangement as at the Latest Practicable Date to which Air China was a party which related to the circumstances in which Air China might or might not invoke or seek to invoke a condition to the privatization proposal.

REASONS FOR AND BENEFITS OF THE PROPOSAL

Air China, a state-owned corporation established under the laws of the PRC, is the leading provider of air passenger, air cargo and airline-related services in the PRC. As at the Latest Practicable Date, Air China was the registered and beneficial owner of 68.4% of the issued capital of CNAC. As disclosed in the Announcement, implementation of the Restructuring Agreement has resulted in, amongst other things, Air China acquiring a 10.16% shareholding in Cathay and, through CNAC, an indirect interest of 7.34% in Cathay. It is the wish of Air China to rationalize its shareholding in Cathay so that Air China will directly control a 17.5% shareholding in Cathay, thus allowing Air China greater influence over Cathay and to equity account for a higher percentage of Cathay's financial results. Consequently, Air China wishes to privatize CNAC so that CNAC will become a private company within the Air China Group.

Furthermore, the announcement of the privatization of CNAC enabled both Air China and CNAC to fulfill one of the conditions of the irrevocable undertaking given to them by On Ling Investments Limited (which beneficially owned approximately 9.75% of the issued share capital of CNAC) to vote in favour of the independent shareholders' resolutions to approve the transactions contemplated in the Restructuring Agreement as mentioned in the section above headed "Background to the Proposal". This irrevocable undertaking was a key component in providing execution certainty for both the Restructuring Agreement and other ancillary agreements.

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Prior to the completion of the Restructuring Agreement, the CNAC Group was principally engaged in the airline operation business through its 43.29% interest in Dragonair and 51% interest in Air Macau. The 43.29% interest in Dragonair contributed to approximately 68.7% and 58.6% of the audited consolidated profit before tax of CNAC for the years ended 31 December 2004 and 31 December 2005 respectively. The interest of Dragonair also contributed to 47.1% and 43.7% of the audited consolidated net assets of CNAC as at 31 December 2004 and 31 December 2005 respectively. By way of contrast, Air Macau made an audited profit before tax (net of dividends received from Menzies Macau Airport Services Ltd.) of HK\$54.6 million, representing approximately 13.4% of the audited consolidated profit before tax of CNAC, for the year ended 31 December 2004 and an audited loss before tax (net of dividends received from Menzies Macau Airport Services Ltd.) of approximately HK\$45.4 million for the year ended 31 December 2005. Accordingly, the interest in Dragonair and, therefore, the airline operation business has formed a substantial part of the CNAC Group's business. Furthermore, CNAC was the single largest shareholder in Dragonair and had four representatives on the board of directors of Dragonair, which had a total of 11 members.

After the completion of the Restructuring Agreement, CNAC no longer has any interest in Dragonair. In turn, CNAC now holds a 7.34% direct equity interest in Cathay, but without any representation on the board of Cathay. Accordingly, the disposal of the 43.29% interest in Dragonair has effectively turned CNAC into a passive investment holding company with a 7.34% minority interest in Cathay. Based on the unaudited proforma consolidated income statement of the CNAC Group for the year ended 31 December 2005 included in the circular of CNAC dated 30 June 2006 issued to its shareholders, the unaudited proforma profit attributable to the shareholders of CNAC would have increased from approximately HK\$225 million to HK\$3,569 million had the sale of CNAC Group's entire interest in Dragonair and the acquisition of the shares in Cathay been completed on 1 January 2005. Based on the unaudited proforma consolidated balance sheet of the CNAC for the year ended 31 December 2005 included in the same CNAC circular, the unaudited proforma net assets of the CNAC Group would have increased from approximately HK\$3,126 million to HK\$6,086 million had the sale of CNAC Group's entire interest in Dragonair and the acquisition of the shares in Cathay been completed on 31 December 2005. Such proforma increase in profit and net asset, however, is an isolated event derived from the disposal of CNAC's interest in Dragonair. Although the CNAC Group continues its airline operation business after the completion of the Restructuring Agreement through its 51% interest in Air Macau, that business has shrunk substantially in terms of revenue and net income attributable primarily to the disposal of the substantial interest in Dragonair. The remaining businesses of the CNAC Group, which now constitute its major businesses, mainly comprise air catering services, airport ground handling services and logistics services in Hong Kong. Therefore, the Minority Shareholders may perceive the CNAC Group's business focus to have shifted more to aviation services than airline operation after the completion of the Restructuring Agreement.

In light of the material changes in the CNAC Group's businesses and prospects as a result of the restructuring, it is the view of the CNAC Board that some of the Minority Shareholders may consider whether they should continue to hold their investments in

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CNAC. Taking this factor into account, the CNAC Board is of the opinion that the Scheme represents a good opportunity for the shareholders to realise their investments in the form of cash proceeds at a premium to the prevailing market price of the Shares.

For the holders of the Scheme Shares, the cancellation price of HK\$2.80 per Scheme Share reflects:

- (i) a premium of approximately 65.9% over the average closing price of approximately HK\$1.69 per Share for the six months up to and including the Last Trading Date;
- (ii) a premium of approximately 50.3% over the average closing price of approximately HK\$1.86 per Share for the three months up to and including the Last Trading Date;
- (iii) a premium of approximately 49.8% over the average closing price of approximately HK\$1.87 per Share for the last 30 trading days up to and including the Last Trading Date;
- (iv) a premium of approximately 52.2% over the average closing price of approximately HK\$1.84 per Share for the last 10 trading days up to and including the Last Trading Date;
- (v) a premium of approximately 45.8% over the average closing price of HK\$1.92 per Share for the last five trading days up to and including the Last Trading Date;
- (vi) a premium of approximately 42.1% over the closing price of HK\$1.97 per Share as quoted on the Stock Exchange on the Last Trading Date;
- (vii) a premium of approximately 1.4% over the closing price of HK\$2.76 per Share as quoted on the Stock Exchange on the Latest Practicable Date;
- (viii) a premium of approximately 199.9% over the audited net asset value per Share as at 31 December 2005 of approximately HK\$0.93, which is equivalent to a multiple of 3.0 times the net asset value (adjusted for year-end dividends) of CNAC of HK\$3,092.7 million and 3,312,680,000 Shares in issue as at 31 December 2005; and
- (ix) a price earnings multiple of approximately 41.2 times based on the audited net profit attributable to the holders of the Shares of approximately HK\$225 million for the financial year ended 31 December 2005 and 3,312,680,000 Shares in issue as at 31 December 2005.

Air China has no present intention whatsoever to divest any of its shareholdings in CNAC. As approximately 68.4% of CNAC is held by Air China, it is unlikely that the Minority Shareholders will receive any other offer from a third party to acquire their Shares if the Scheme does not become effective.

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EFFECT OF THE SCHEME ON THE SHAREHOLDING STRUCTURE

After the issue of the Announcement, it was decided by Air China that CNAC would, instead of becoming a wholly-owned subsidiary of Air China, become a 99.9% indirectly owned subsidiary of Air China on the implementation of the Scheme. The tables below set out the shareholding structures of CNAC as at the Latest Practicable Date and, assuming that none of the Option holders will exercise any of their outstanding Options, on the implementation of the Scheme.

As at the Latest Practicable Date

	Number of Shares	%
Air China	2,264,628,000	68.4
Minority Shareholders:		
Merrill Lynch PF&S (<i>Note 1</i>)	14,000	0
Merrill Lynch International (<i>Note 2</i>)	4,000	0
Other Minority Shareholders	1,048,034,000	31.6
Subtotal	1,048,052,000	31.6
Total	3,312,680,000	100.0

Note 1: Although Merrill Lynch PF&S is a Minority Shareholder, it is presumed to be a party acting in concert with Air China under the Takeovers Code by virtue of it being a company under the same ultimate control (as defined in the Takeovers Code) as Merrill Lynch, which is one of the exclusive financial advisers to Air China in relation to the Scheme. Accordingly, Merrill Lynch PF&S is prohibited by the Takeovers Code from voting at the Court Meeting to approve the Scheme.

Note 2: Merrill Lynch International, which is a Minority Shareholder, is recognised by the Executive as an exempt principal trader and is therefore not considered to be a party acting in concert with Air China for the purposes of the Takeovers Code. However, Merrill Lynch International, as an exempt principal trader connected with Air China, is prohibited from voting at the Court Meeting to approve the Scheme pursuant to Rule 35.4 of the Takeovers Code. In the circumstances, although the 4,000 Shares held by Merrill Lynch International will be part of the Scheme Shares, such Shares will be excluded from the total number of the disinterested Shares when calculating the 10% voting requirement under Rule 2.10 of the Takeovers Code.

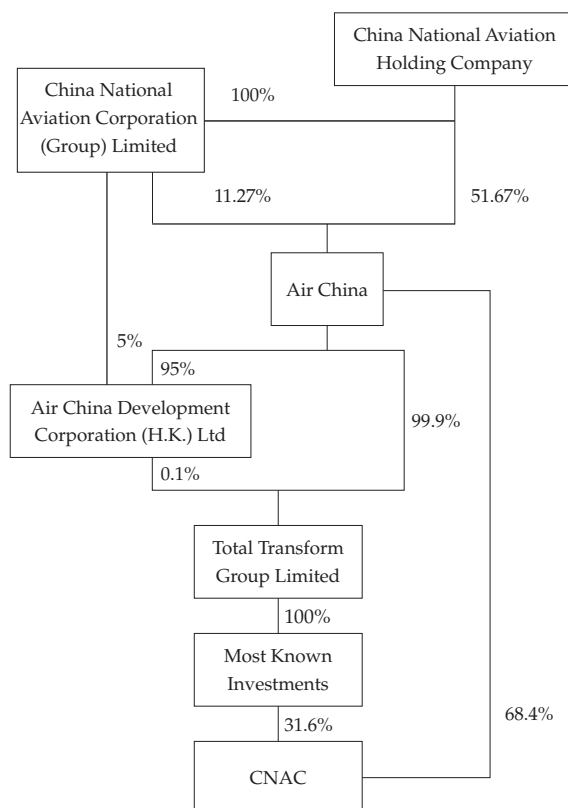
After the implementation of the Scheme

Shareholders	Number of Shares	%
Air China	2,264,628,000	68.4
Most Known Investments (<i>Note 1</i>)	1,048,052,000	31.6
Total	3,312,680,000	100.0

Note 1: Most Known Investments is a wholly-owned subsidiary of Total Transform Group Limited, a company incorporated in the British Virgin Islands and is 99.9% owned by Air China. The remaining 0.1% shareholding of Total Transform Group Limited is owned by Air China Development Corporation (H.K.) Ltd, a 95% owned subsidiary of Air China, with the remaining 5% indirectly owned by the controlling shareholder of Air China, China National Aviation Holding Company.

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The chart below shows the shareholding structure of CNAC when the Scheme becomes effective.



MATERIAL INTERESTS OF DIRECTORS AND EFFECT OF SCHEME ON SUCH INTERESTS

Amongst the six executive directors on the CNAC Board, three of them are related to Air China: Mr. Kong Dong, the chairman of the CNAC Board, is also a director of Air China; Mr. Zhang Xianlin is the chairman of the supervisory board of Air China; and Mr. Zhao Xiaohang is a representative of Air China on the CNAC Board. Of the five independent non-executive directors of CNAC, Mr. Hu Hung Lick, Henry also holds the same office in Air China. All of them are therefore parties acting in concert with Air China.

Except as mentioned above and apart from the effect of the Scheme on the Option interests of Messrs. Chuang Shih Ping and Tsang Hing Kwong, Thomas as described in the section above entitled "Summary of the Proposal", none of the directors on the CNAC Board, whether as such directors or shareholders or creditors of CNAC or otherwise, has any material interests in the Scheme. Accordingly, other than on such Option interests, neither the Scheme nor the privatization proposal, as described in Sections 3 (a), 4 and 5 headed respectively "Interests of Directors and Chief Executive", "Arrangements Affecting Directors of CNAC" and "Directors' Service Contracts" in Appendix II to this document, has any effect on the interests, if any, of the CNAC directors.

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INFORMATION ON THE CNAC GROUP

Business

CNAC was incorporated in Hong Kong in 1997 and was listed on the Stock Exchange on 17 December 1997, trading under stock code 1110. The principal activity of CNAC is to act as an investment holding company.

The principal activities of the CNAC Group are airline operations and aviation related businesses. Following the completion of the Restructuring Agreement, the core businesses of the CNAC Group comprise air transportation services (Air Macau Company Limited, Macau Asia Express Limited and Cathay), airline catering services (Beijing Air Catering Co. Ltd., Southwest Air Catering Company Limited and LSG Lufthansa Service Hong Kong Ltd.), airport ground handling services (Jardine Airport Service Ltd. and Menzies Macau Airport Services Ltd.) and logistics services (Tradeport Hong Kong Ltd.).

Financial information

A summary of the CNAC Group's audited consolidated results for each of the two years ended 31 December 2004 and 2005 is set out below:

	For the year ended	
	31 December	
	2004	2005
	HK\$'000	HK\$'000
Turnover	1,890,710	2,620,033
Profit before taxation	406,808	221,966
Profit after taxation	394,464	211,924
Profit attributable to shareholders	360,969	225,000
Basic earnings per Share (HK cents)	10.90	6.79
Dividends per Share (HK cents)		
– Interim	0.6	0.8
– Final	1.0	1.0

The attention of the Minority Shareholders is also drawn to Appendix I to this document which sets out the financial information of the CNAC Group.

Net asset value

Based on the audited consolidated balance sheets of the CNAC Group as at 31 December 2004 and 2005, the net asset values of the CNAC Group as at those dates were approximately HK\$2,954,208,000 and HK\$3,125,837,000 respectively, or approximately HK\$0.89 per Share and HK\$0.94 per Share respectively, based on 3,312,680,000 Shares in issue, being the same as the number of the Shares in issue at the Latest Practicable Date.

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Earnings

The CNAC Group's audited consolidated profit attributable to the shareholders of CNAC for the year ended 31 December 2005 amounted to approximately HK\$225,000,000, representing earnings of approximately HK\$0.07 per Share.

Dividends

Save for the payment of a final dividend of HK\$0.01 per Share as approved by the shareholders at the annual general meeting of CNAC held on 25 May 2006, CNAC has neither declared nor paid nor made any dividend or distribution of any kind.

Liquidity and financial resources

The CNAC Group generally finances its operations with cash flow generated internally. As at 31 December 2005, the CNAC Group had cash and cash equivalents of a total amount of approximately HK\$1,000 million and net current assets of approximately HK\$692 million. The CNAC Group consistently maintained a strong working capital during the year ended 31 December 2005. The current liabilities of the CNAC Group as at that date were approximately HK\$675 million.

INFORMATION ON THE AIR CHINA GROUP

Air China is a company incorporated in the PRC on 30 September 2004 and the shares of which were listed on the Main Board of the Stock Exchange on 15 December 2004 under stock code 753. Air China's shares were also listed on the London Stock Exchange on 15 December 2004 under stock code AIRC by way of a secondary listing and on the Shanghai Stock Exchange on 18 August 2006 under stock code 601111. As at the Latest Practicable Date, China National Aviation Holding Company, a state-owned company established under the laws of the PRC, directly and indirectly owned 51.67% of Air China. Air China is a leading provider of air passenger, air cargo and airline-related services in the PRC.

The number of Air China shares in issue was 12,251,362,273 as at the Latest Practicable Date.

FUTURE INTENTIONS REGARDING CNAC

On the assumption that the Scheme becomes effective, it is the intention of Air China that the listing of the Shares from the Stock Exchange will be withdrawn pursuant to the Listing Rules. The listing of the Shares will not be withdrawn if the Scheme is withdrawn or lapses or is not approved. Air China has no current intention to introduce any major change to the existing operating and management structures of CNAC, nor does Air China have any current intention to discontinue the employment of any employee of the CNAC Group irrespective of whether or not the Scheme becomes effective.

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SHARE CERTIFICATES, DEALINGS AND LISTING

Upon the Scheme becoming effective, all the Scheme Shares and instruments of transfer will be cancelled and all certificates representing the Scheme Shares will cease to have effect as documents or evidence of title.

Following the sanction of the Scheme by the Court, CNAC will apply for the withdrawal of the listing of the Shares on the Stock Exchange pursuant to Rule 6.15 of the Listing Rules. On the assumption that the Scheme becomes effective on 10 January 2007, dealings in the Shares on the Stock Exchange are expected to cease after the close of the trading session on 4 January 2007 and the listing of the Shares on the Stock Exchange is expected to be withdrawn with effect from 11 January 2007.

The Minority Shareholders will be notified by way of a press announcement of the exact dates on which the Scheme and the withdrawal of the listing of the Shares on the Stock Exchange shall have become effective.

As pointed out above, the listing of the Shares on the Stock Exchange will not be withdrawn if the Scheme is withdrawn, lapses or is not approved.

MONETARY ENTITLEMENTS UNDER THE SCHEME

Cheques for the payment of the monetary entitlements under the Scheme shall be despatched to the holders of the Scheme Shares or persons nominated by them within ten days of the Effective Date. Assuming that the Scheme becomes effective on 10 January 2007, it is expected that such cheques will be despatched on or before 20 January 2007. Unless otherwise indicated in writing to the share registrar of CNAC, all such cheques will be sent by post (where appropriate, by airmail) in pre-paid envelopes addressed to such shareholders in the following manner:

- (a) in the case of a sole holder of the Scheme Shares, to the registered address of that holder as appearing on the register of members of CNAC at the Record Time; and
- (b) in the case of joint holders of the Scheme Shares, to the registered address as appearing on the register of members of CNAC at the Record Time of that joint holder whose name then stands first on the register of members of CNAC in respect of the joint holding.

Each cheque will be made payable to the order of the person to whom the envelope containing the cheque is addressed, and the encashment of the cheque will be a good discharge to Air China for the monies represented by the cheque. All cheques will be posted at the risk of the addressees and other persons entitled to the monies represented by the cheques. Neither CNAC nor Air China will in any way be liable for any loss or delay in transmission.

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On or after the day falling six months after the posting of the cheques, Air China will have the right to cancel or countermand payment of any cheque which has not been encashed or has been returned uncashed, and will place the monies represented by such cheques in a deposit account in CNAC's name with a licensed bank in Hong Kong to be selected by CNAC. CNAC will hold those monies for six years from the Effective Date. During that period, CNAC will make payments out of the sum to any person who has satisfied CNAC that he is entitled to payment under the Scheme and the cheque previously sent to him has not been encashed. Any payment so made by CNAC will include any interest accrued on the sum to which he is entitled, calculated at the annual rate prevailing from time to time at the licensed bank, subject (where applicable) to the deduction of any interest or withholding or other tax and any other deduction required by law as well as all costs and expenses incurred in relation to the payment.

CNAC will exercise its absolute discretion in determining whether or not it is satisfied that any person is entitled to payment out of the deposit account, and a certificate issued by CNAC to the effect that a person is so entitled or not so entitled will be conclusive and binding upon all persons claiming an interest in the monies deposited in the bank.

Upon the expiration of six years from the Effective Date, Air China will be released from any further obligation to make any payment under the Scheme, and CNAC will accordingly transfer to Air China the balance of the sums deposited in the licensed bank and accrued interest, subject (if applicable) to the deduction of any interest or withholding tax and any other deduction required by law and all expenses incurred in the transfer.

The above arrangements will take effect in accordance with, and subject to, all prohibitions and conditions, if any, imposed by law.

OVERSEAS HOLDERS OF THE SCHEME SHARES

As a result of the Scheme, those holders of the Scheme Shares who are not resident in Hong Kong may be subject to the laws of other jurisdictions. Such holders should observe and comply with any applicable legal or regulatory requirements. It is the responsibility of the overseas holders of the Scheme Shares to satisfy themselves as to the full observance of the laws of the relevant jurisdictions in connection with the Scheme, including obtaining any governmental or exchange control or other consents which may be required, the compliance with other necessary formalities and payment of any transfer or other tax due in such jurisdictions.

TAXATION

As the cancellation of the Scheme Shares under the Scheme does not constitute a sale and purchase of a Hong Kong stock, no stamp duty will be payable pursuant to the Stamp Duty Ordinance, Chapter 117 of the Laws of Hong Kong.

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The holders of the Scheme Shares, whether in Hong Kong or in other jurisdictions, are recommended to consult their own professional advisers if they are in any doubt as to the taxation implications of the Scheme and, in particular, whether the receipt of the monetary entitlements would make such holder liable to taxation in Hong Kong or other jurisdictions.

COURT MEETING AND EXTRAORDINARY GENERAL MEETING

In accordance with the direction of the Court, the Court Meeting has been convened for the purpose of considering and, if thought fit, passing the resolution to approve the Scheme, with or without modifications. The Scheme will be subject to the approval at the Court Meeting in the manner referred to in paragraph (a) of the section above headed "Conditions of the Scheme" in this Explanatory Statement.

The Extraordinary General Meeting has been convened for the purpose of considering and, if thought fit, passing a special resolution to approve and give effect to the Scheme, specifically the reduction of the capital of CNAC. The special resolution will be passed provided that it is approved by a majority of at least three-fourths of those shareholders of CNAC present and voting in person or by proxy at the Extraordinary General Meeting. All of the shareholders of CNAC, including Air China and parties acting in concert or connected with Air China, will be entitled to attend and vote at the Extraordinary General Meeting. If the Scheme is approved at the Court Meeting, it is the intention of Air China to vote in favour of the special resolution to be proposed at the Extraordinary General Meeting. Merrill Lynch PF&S and Merrill Lynch International have indicated that they will voluntarily abstain from voting at the Extraordinary General Meeting.

Notice of the Court Meeting is set out on pages 150 to 151 of this document. The Court Meeting will be held at Tianshan – Lushan Room, Level 5, Island Shangri-La, Hong Kong, Pacific Place, Supreme Court Road, Central, Hong Kong on Friday, 15 December 2006 at 11:00 a.m..

Notice of the Extraordinary General Meeting is set out on pages 152 to 153 of this document. The Extraordinary General Meeting will be held at the same place and date at 11:30 a.m. or immediately following the Court Meeting.

POLL PROCEDURE

In accordance with Article 68 of CNAC's articles of association, at any general meeting, including the Extraordinary General Meeting, a resolution put to the vote of the meeting shall be decided on a show of hands unless a poll is required under the Listing Rules or, before or on the declaration of the result of the show of hands, a poll is demanded by:

- (i) the chairman of the meeting; or
- (ii) at least three members present in person or by proxy or by their duly authorized corporate representatives entitled to vote at the meeting; or

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- (iii) any member or members present in person or by proxy or by their duly authorized corporate representatives representing not less than one-tenth of the total voting rights of all of the members having the right to vote at the meeting; or
- (iv) a member or members present in person or by proxy or by their duly authorized corporate representatives holding the Shares conferring a right to vote at the meeting, being Shares on which an aggregate sum has been paid up equal to not less than one-tenth of the total sum paid up on all the Shares conferring that right.

ACTIONS TO BE TAKEN

A pink form of proxy for use at the Court Meeting and a white form of proxy for use at the Extraordinary General Meeting are enclosed with this document.

Whether or not a holder of the Shares who is entitled to vote is able to attend and vote at the Court Meeting or the Extraordinary General Meeting in person, he is strongly urged to complete and sign the enclosed pink form of proxy in respect of the Court Meeting and the enclosed white form of proxy in respect of the Extraordinary General Meeting in accordance with the instructions respectively printed on them and to return the completed forms to the share registrar of CNAC, Computershare Hong Kong Investor Services Limited, at 17th Floor, Hopewell Centre, 183 Queen's Road East, Hong Kong as soon as possible, but in any case not later than the following respective times:

- (a) in the case of the pink form of proxy for use at the Court Meeting, the Minority Shareholders who will be entitled to vote are requested to lodge the form with the share registrar not later than 11:00 a.m. on Wednesday, 13 December 2006, but if it is not so lodged, it may be handed to the chairman of the Court Meeting at the Court Meeting; and
- (b) in order to be valid, the white form of proxy for use at the Extraordinary General Meeting must be deposited at the office of the share registrar by the shareholders of CNAC not later than 11:30 a.m. on Wednesday, 13 December 2006.

The completion and return of a form of proxy for the Court Meeting or the Extraordinary General Meeting will not preclude a member from attending and voting in person at the relevant meeting. In such event, his completed form of proxy for that meeting will be deemed to have been revoked.

Assuming that all of the Conditions are fulfilled or waived (as applicable), the Scheme will become effective on the Effective Date, which is expected to be 10 January 2007. Further announcements will be made on the results of the Court Meeting and the Extraordinary General Meeting and, if all the resolutions are passed at both meetings, the last day for dealing in the Shares, the Record Time, the result of the hearing of the petition for the sanction of the Scheme by the Court, the Effective Date and the date of the withdrawal of the listing of the Shares on the Stock Exchange, as the case may be.

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FURTHER INFORMATION

Further information in relation to the privatization proposal is set out in the Appendices to this document, all of which form part of this Explanatory Statement.

(A) CONSOLIDATED FINANCIAL INFORMATION OF THE CNAC GROUP FOR THE YEARS ENDED 31 DECEMBER 2003, 2004 and 2005

There was no audit qualification in any of the financial statements as set out in the annual reports of CNAC for the past three financial years. There were no extraordinary or exceptional items in the financial statements for any of the past three financial years.

Subject to the adoption of the definitions in this document, set out below are the consolidated financial information of the CNAC Group for the three years ended 31 December 2003, 2004 and 2005 that are extracted from the accountants' report as set out in Appendix I headed "Financial Information of the Group" to the circular dated 30 June 2006 issued to the shareholders of CNAC in connection with the sale of CNAC Group's entire interest in Dragonair and the acquisition of the shares of Cathay.

(I) FINANCIAL INFORMATION**(a) Consolidated income statements**

	Note	Year ended 31 December		
		2003 HK\$'000	2004 HK\$'000	2005 HK\$'000
Turnover	7	1,227,031	1,890,710	2,620,033
Other revenues	7	16,321	12,991	46,985
Total revenues		<u>1,243,352</u>	<u>1,903,701</u>	<u>2,667,018</u>
Other gains	8	9,970	10,047	39,268
Staff costs	9	(215,410)	(249,786)	(388,649)
Passenger catering and service costs		(79,223)	(103,353)	(237,545)
Fuel costs		(191,125)	(387,918)	(654,018)
Route operating costs		(309,515)	(437,812)	(529,051)
Aircraft maintenance costs		(153,868)	(139,719)	(226,553)
Aircraft leases and equipment costs		(324,903)	(355,718)	(444,882)
Depreciation and amortisation costs		(87,497)	(86,160)	(78,221)
Sales and promotion costs		(50,328)	(61,078)	(92,395)
Other operating costs		(65,036)	(75,471)	(107,289)
Total operating expenses		<u>(1,476,905)</u>	<u>(1,897,015)</u>	<u>(2,758,603)</u>
Operating (loss)/profit	10	(223,583)	16,733	(52,317)
Finance costs	11	–	(375)	(2,960)
Share of profits less losses of associates	21(a)	106,690	390,450	277,243
Profit before income tax		(116,893)	406,808	221,966
Income tax	12	30,188	(12,344)	(10,042)
(Loss)/profit for the year		<u>(86,705)</u>	<u>394,464</u>	<u>211,924</u>

APPENDIX I

FINANCIAL INFORMATION
RELATING TO THE CNAC GROUP

	<i>Note</i>	Year ended 31 December		
		2003 <i>HK\$'000</i>	2004 <i>HK\$'000</i>	2005 <i>HK\$'000</i>
Attributable to:				
Equity holders of CNAC	13	(17,295)	360,969	225,000
Minority interests		(69,410)	33,495	(13,076)
		<u>(86,705)</u>	<u>394,464</u>	<u>211,924</u>
Dividends	14	<u>29,761</u>	<u>53,003</u>	<u>59,628</u>
		HK cents	HK cents	HK cents
(Loss)/earnings per Share	15			
– Basic		<u>(0.52)</u>	<u>10.90</u>	<u>6.79</u>
– Diluted		<u>(0.52)</u>	<u>10.81</u>	<u>6.72</u>

(b) Consolidated balance sheets

	Note	At 31 December		
		2003 HK\$'000	2004 HK\$'000	2005 HK\$'000
ASSETS				
Non-current assets				
Property, plant and equipment	16	399,378	495,786	471,692
Land use right	17	–	2,355	2,274
Intangible assets	18	306,195	529,249	529,240
Interests in associates	21(a)	1,198,012	1,590,158	1,627,594
Loans to associates	21(b)	82,103	82,103	47,097
Lease and equipment deposits		83,041	68,762	60,109
Deferred income tax assets	34	30,333	21,777	23,427
Pledged bank deposits	27	25,637	67,455	88,943
		<u>2,124,699</u>	<u>2,857,645</u>	<u>2,850,376</u>
Current assets				
Loan to an associate	22	–	–	18,060
Investment securities	23	–	18,313	–
Derivative financial instruments	24	–	–	11,957
Inventories	25	50,824	54,045	53,273
Trade and other receivables	26	154,056	258,465	283,544
Cash and cash equivalents	27	1,036,929	746,793	999,833
		<u>1,241,809</u>	<u>1,077,616</u>	<u>1,366,667</u>
Total assets		<u>3,366,508</u>	<u>3,935,261</u>	<u>4,217,043</u>
EQUITY				
Capital and reserves attributable to CNAC's equity holders				
Share capital	28	331,268	331,268	331,268
Reserves	29	2,284,260	2,589,813	2,761,442
Proposed final dividend	29	19,876	33,127	33,127
		<u>2,635,404</u>	<u>2,954,208</u>	<u>3,125,837</u>
Minority interests		<u>248,797</u>	<u>282,292</u>	<u>227,352</u>
Total equity		<u>2,884,201</u>	<u>3,236,500</u>	<u>3,353,189</u>

		At 31 December		
	Note	2003 HK\$'000	2004 HK\$'000	2005 HK\$'000
LIABILITIES				
Non-current liabilities				
Provision for overhaul and major checks	30	64,869	91,939	154,904
Provision for housing allowances	31	–	–	34,126
		<u>64,869</u>	<u>91,939</u>	<u>189,030</u>
Current liabilities				
Trade and other payables	32	309,382	416,572	514,623
Sales in advance of carriage		107,469	118,061	132,394
Current income tax liabilities		587	2,972	2,436
Short-term bank loans – unsecured	33	–	69,217	25,371
		<u>417,438</u>	<u>606,822</u>	<u>674,824</u>
Total liabilities		<u>482,307</u>	<u>698,761</u>	<u>863,854</u>
Total equity and liabilities		<u>3,366,508</u>	<u>3,935,261</u>	<u>4,217,043</u>
Net current assets		<u>824,371</u>	<u>470,794</u>	<u>691,843</u>
Total assets less current liabilities		<u>2,949,070</u>	<u>3,328,439</u>	<u>3,542,219</u>

(c) Balance sheets

	Note	At 31 December		
		2003 HK\$'000	2004 HK\$'000	2005 HK\$'000
ASSETS				
Non-current assets				
Interests in subsidiaries	19	1,518,124	1,981,860	2,014,820
Interests in associates	21(a)	51,789	51,789	51,789
Loan to an associate	21(b)	37,560	34,560	–
		<u>1,607,473</u>	<u>2,068,209</u>	<u>2,066,609</u>
Current assets				
Loan to an associate	22	–	–	18,060
Trade and other receivables	26	4,664	687	921
Cash and cash equivalents	27	813,612	381,969	509,140
		<u>818,276</u>	<u>382,656</u>	<u>528,121</u>
Total assets		<u>2,425,749</u>	<u>2,450,865</u>	<u>2,594,730</u>
EQUITY				
Capital and reserves				
Share capital	28	331,268	331,268	331,268
Reserves	29	2,070,395	2,082,127	2,225,967
Proposed final dividend	29	19,876	33,127	33,127
Total equity		<u>2,421,539</u>	<u>2,446,522</u>	<u>2,590,362</u>
LIABILITIES				
Current liabilities				
Trade and other payables	32	<u>4,210</u>	<u>4,343</u>	<u>4,368</u>
Total equity and liabilities		<u>2,425,749</u>	<u>2,450,865</u>	<u>2,594,730</u>
Net current assets		<u>814,066</u>	<u>378,313</u>	<u>523,753</u>
Total assets less current liabilities		<u>2,421,539</u>	<u>2,446,522</u>	<u>2,590,362</u>

(d) Consolidated statements of changes in equity

	Attributable to the CNAC's equity holders				Total HK\$'000
	Share capital HK\$'000	Other reserves HK\$'000	Retained earnings HK\$'000	Minority interests HK\$'000	
Balance at 1 January 2003	331,931	1,442,404	921,785	318,207	3,014,327
Share of currency translation differences of associates	-	-	59	-	59
Share of deficit on revaluation of investment securities of an associate	-	(1,716)	-	-	(1,716)
Net (expense)/income recognised directly in equity	-	(1,716)	59	-	(1,657)
Loss for the year	-	-	(17,295)	(69,410)	(86,705)
Total recognised loss for 2003	-	(1,716)	(17,236)	(69,410)	(88,362)
Repurchase of own shares (note 28(b))	(663)	663	(5,325)	-	(5,325)
Dividends	-	-	(36,439)	-	(36,439)
Balance at 31 December 2003	<u>331,268</u>	<u>1,441,351</u>	<u>862,785</u>	<u>248,797</u>	<u>2,884,201</u>
Balance at 1 January 2004	331,268	1,441,351	862,785	248,797	2,884,201
Share of currency translation differences of associates	-	-	51	-	51
Share of deficit on revaluation of investment securities of an associate	-	(2,464)	-	-	(2,464)
Net (expense)/income recognised directly in equity	-	(2,464)	51	-	(2,413)
Profit for the year	-	-	360,969	33,495	394,464
Total recognised (loss)/income for 2004	-	(2,464)	361,020	33,495	392,051
Transfer	-	43	(43)	-	-
Dividends	-	-	(39,752)	-	(39,752)
Balance at 31 December 2004	<u>331,268</u>	<u>1,438,930</u>	<u>1,184,010</u>	<u>282,292</u>	<u>3,236,500</u>

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**FINANCIAL INFORMATION
RELATING TO THE CNAC GROUP**

	Attributable to the CNAC's equity holders				Total HK\$'000
	Share capital HK\$'000	Other reserves HK\$'000	Retained earnings HK\$'000	Minority interests HK\$'000	
Balance at 1 January 2005	331,268	1,438,930	1,184,010	282,292	3,236,500
Share of opening adjustments on adoption of HKAS 39 by associates	–	(20,056)	1,033	–	(19,023)
Balance at 1 January 2005, as restated	331,268	1,418,874	1,185,043	282,292	3,217,477
Share of currency translation differences of associates	–	–	84	–	84
Share of fair value gains on derivative financial instruments of associates (note 29 (b))	–	25,319	–	–	25,319
Currency translation differences	–	(123)	–	–	(123)
Net income recognised directly in equity	–	25,196	84	–	25,280
Profit for the year	–	–	225,000	(13,076)	211,924
Total recognised income/(loss) for 2005	–	25,196	225,084	(13,076)	237,204
Transfer	–	6,599	(6,599)	–	–
Dividends	–	–	(59,628)	(41,864)	(101,492)
Balance at 31 December 2005	<u>331,268</u>	<u>1,450,669</u>	<u>1,343,900</u>	<u>227,352</u>	<u>3,353,189</u>

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FINANCIAL INFORMATION
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(e) Consolidated cash flow statements

	Note	Year ended 31 December		
		2003 HK\$'000	2004 HK\$'000	2005 HK\$'000
Cash flows from operating activities				
Cash (used in)/generated from operations	35(a)	(100,629)	161,645	186,684
Overseas taxation paid		(9,953)	(1,009)	(12,228)
Interest paid		–	(375)	(2,960)
Net cash (used in)/from operating activities		<u>(110,582)</u>	<u>160,261</u>	<u>171,496</u>
Cash flows from investing activities				
Interest received		9,910	4,891	20,159
Purchase of an associate		–	(115,069)	–
Purchase of jointly controlled entities	35(b)	–	(326,753)	–
Sale of an investment security		–	–	19,520
Dividends received from associates		69,535	110,960	246,187
Increase in pledged deposits		(12,482)	(35,698)	(21,488)
Repayment of loan from an associate		(5,250)	–	16,500
Purchase of property, plant and equipment		(27,467)	(38,409)	(54,300)
Sale of property, plant and equipment		246	722	304
Net cash from/(used in) investing activities		<u>34,492</u>	<u>(399,356)</u>	<u>226,882</u>
Cash flows from financing activities				
Repurchase of own shares	28(b)	(5,325)	–	–
Dividends paid to CNAC's equity holders		(39,670)	(39,752)	(59,628)
Dividends paid to minority interests		–	–	(41,864)
Proceeds from short-term bank loans		–	–	35,926
Repayments of short-term bank loans		–	(11,289)	(79,772)
Net cash used in financing activities		<u>(44,995)</u>	<u>(51,041)</u>	<u>(145,338)</u>
Net (decrease)/increase in cash and cash equivalents		(121,085)	(290,136)	253,040
Cash and cash equivalents at 1 January		<u>1,158,014</u>	<u>1,036,929</u>	<u>746,793</u>
Cash and cash equivalents at 31 December	27	<u><u>1,036,929</u></u>	<u><u>746,793</u></u>	<u><u>999,833</u></u>

(II) NOTES TO THE FINANCIAL INFORMATION**1. General information**

CNAC is a limited liability company incorporated in Hong Kong on 3 February 1997, the shares of which were listed on the Main Board of the Stock Exchange in December 1997. The CNAC Group, its jointly controlled entities and its associates are principally engaged in the airline operations, airport ground handling services, airline catering services, logistics and other businesses.

The address of CNAC registered office is 5th Floor, CNAC House, 12 Tung Fai Road, Hong Kong International Airport, Lantau.

The CNAC directors (the "Directors") regard Air China, a company incorporated in the PRC and listed on the Main Board of the Stock Exchange, as being the immediate holding company. The parent company of Air China is China National Aviation Holding Company ("CNAH"), a state-owned enterprise established in the PRC.

2. Basis of preparation

The financial information has been prepared in accordance with Hong Kong Financial Reporting Standards ("HKFRS") and Hong Kong Accounting Standards ("HKAS") and interpretations ("HKAS-Int") (collectively "HKFRSs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"). The financial information has been prepared under the historical cost convention except that, as disclosed in the accounting policies below, available-for-sale investments and derivative financial instruments are carried at fair value.

The preparation of the financial information in conformity with HKFRSs requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying the CNAC Group's accounting policies. The areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the financial information, are disclosed in note 5.

3. Standards, interpretations and amendments to published standards that are not yet effective

The HKICPA has issued the following amendments, new standards and interpretations which are not yet effective as of the date of the financial information and will be relevant to the CNAC Group:

	Effective for accounting periods beginning on or after
HKFRS Interpretation 4 "Determining whether an Arrangement contains a Lease"	1 January 2006
Amendments to HKAS 19 "Employee Benefits – Actuarial Gains and Losses, Group Plans and Disclosures"	1 January 2006
Amendments to HKAS 39 "Financial Instruments: Recognition and Measurement":	
– Cash Flow Hedge Accounting of Forecast Intragroup Transactions	1 January 2006
– The Fair Value Option	1 January 2006
Amendments, as a consequence of the Hong Kong Companies (Amendment) Ordinance 2005, to:	
– HKAS 1 "Presentation of Financial Statements"	1 January 2006
– HKAS 27 "Consolidated and Separate Financial Statements"	1 January 2006
– HKFRS 3 "Business Combinations"	1 January 2006
Amendments to HKAS 39 "Financial Instruments: Recognition and Measurement" and HKFRS 4 "Insurance Contracts":	
– "Financial Guarantee Contracts"	1 January 2006
HKFRS 7 "Financial Instruments: Disclosures"	1 January 2007
Amendments to HKAS 1 "Presentation of Financial Statements: Capital Disclosures"	1 January 2007

The CNAC Group has not early adopted the above standards, interpretations and amendments in the financial information for the year ended 31 December 2005. The CNAC Group has already commenced an assessment of the related impact to the CNAC Group but is not yet in a position to state whether substantial changes to the CNAC Group's accounting policies and presentation of the financial information will be resulted.

4. Summary of significant accounting policies

The significant accounting policies applied in the preparation of the financial information are set out below:

4.1 *Group accounting*

The consolidated financial statements of CNAC include the financial statements of CNAC and its subsidiaries made up to 31 December.

(a) Subsidiaries

Subsidiaries are those entities in which CNAC, directly or indirectly, controls the composition of the board of directors, controls more than half of the voting power or holds more than half of the issued share capital.

Subsidiaries are fully consolidated from the date on which control is transferred to the CNAC Group. They are de-consolidated from the date that control ceases.

The purchase method of accounting is used to account for the acquisition of subsidiaries by the CNAC Group. The cost of an acquisition is measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date, irrespective of the extent of any minority interest. The excess of the cost of acquisition over the fair value of the CNAC Group's share of the identifiable net assets acquired is recorded as goodwill. If the cost of acquisition is less than the fair value of the net assets of the subsidiary acquired, the difference is recognised directly in the income statement.

Intercompany transactions, balances and unrealised gains on transactions between group companies are eliminated. Unrealised losses are also eliminated but considered an impairment indicator of an impairment of the asset transferred. Accounting policies of subsidiaries have been changed where necessary to ensure consistency with the policies adopted by the CNAC Group.

In CNAC's balance sheet the investments in subsidiaries are stated at cost less provision for impairment losses. The results of subsidiaries are accounted for by CNAC on the basis of dividend received and receivable.

(b) Associates

Associates are all entities over which the CNAC Group has significant influence but not control, generally accompanying a shareholding of between 20% and 50% of the voting rights. Investments in associates are accounted for using the equity method of accounting and are initially recognised at cost. The CNAC Group's investment in associates includes goodwill (net of any accumulated impairment loss) identified on acquisition.

The CNAC Group's share of its associates' post-acquisition profits or losses is recognised in the income statement, and its share of post-acquisition movements in reserves is recognised in reserves. The cumulative post-acquisition movements are adjusted against the carrying amount of the investment. When the CNAC Group's share of losses in an associate equals or exceeds its interest in the associate, including any other unsecured receivables, the CNAC Group does not recognise further losses, unless it has incurred obligations or made payments on behalf of the associate.

Unrealised gains on transactions between the CNAC Group and its associates are eliminated to the extent of the CNAC Group's interest in the associates. Unrealised losses are also eliminated unless the transaction provides evidence of an impairment of the asset transferred. Accounting policies of associates have been changed where necessary to ensure consistency with the policies adopted by the CNAC Group.

In CNAC's balance sheet the interests in associates are stated at cost less provision for impairment losses. The results of associates are accounted for by CNAC on the basis of dividend received and receivable.

(c) Jointly controlled entities

The CNAC Group's interests in jointly controlled entities are accounted for by proportionate consolidation. The CNAC Group combines its share of the jointly controlled entities' individual income and expenses, assets and liabilities and cash flows on a line-by-line basis with similar items in the CNAC Group's financial statements. The CNAC Group recognises the portion of gains or losses on the sale of assets by the CNAC Group to the jointly controlled entity that it is attributable to the other venturers. The CNAC Group does not recognise its share of profits or losses from the jointly controlled entity that result from the CNAC Group's purchase of assets from the jointly controlled entity until it resells the assets to an independent party. However, a loss on the transaction is recognised immediately if the loss provides evidence of a reduction in the net realisable value of current assets, or an impairment loss.

4.2 *Segment reporting*

In accordance with the CNAC Group's internal financial reporting policies, the CNAC Group has determined that the primary segment reporting is by business segments and the secondary segment reporting is by geographical segments.

A business segment is a group of assets and operations engaged in providing products or services that are subject to risks and returns that are different from those of other business segments. A geographical segment is engaged in providing products or services within a particular economic environment that are subject to risks and returns that are different from those of segments operating in other economic environments.

Unallocated costs represent corporate expenses. Segment assets consist primarily of intangible assets, property, plant and equipment, land use right, lease and equipment deposits, derivative financial instruments, inventories, trade and other receivables and operating cash and mainly exclude interests in associates and non-operating bank balances and cash. Segment liabilities comprise operating liabilities and mainly exclude current income tax liabilities. Capital expenditure comprises additions to intangible assets, land use right and property, plant and equipment, including additions resulting from acquisitions through business combinations.

In respect of geographical segment reporting, turnover and operating profit by geographical segments is based on the following criteria:

- (i) Traffic revenue from inbound and outbound services between Macau and overseas markets is attributed to the geographical area in which the relevant overseas origin/destination lies.
- (ii) Revenue from sale of goods is attributed on the basis of where the goods are sold.

Total assets and capital expenditure are where the assets are located.

4.3 *Foreign currency translation*

(a) Functional and presentation currency

Items included in the financial statements of each entity in the CNAC Group are measured using the currency of the primary economic environment in which the entity operates (“the functional currency”). The functional currency of CNAC is MOP. As CNAC is incorporated and listed in Hong Kong, the Directors regard Hong Kong dollar as the presentation currency of CNAC. Accordingly, the financial information is presented in Hong Kong dollar.

(b) Transactions and balances

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement, except when deferred in equity as qualifying cash flow hedges or qualifying net investment hedges.

Translation difference on non-monetary financial assets, such as equities classified as available-for-sale investments, are included in the investments revaluation reserve in equity.

(c) Group companies

The results and financial position of all the group entities (none of which has the currency of a hyperinflationary economy) that have a functional currency different from the presentation currency are translated into the presentation currency as follows:

- (i) assets and liabilities for each balance sheet presented are translated at the closing rate at the date of that balance sheet;
- (ii) income and expenses for each income statement are translated at average exchange rates (unless this average is not a reasonable approximation of the cumulative effect of the rates prevailing on the transaction dates, in which case income and expenses are translated at the dates of the transactions); and
- (iii) all resulting exchange differences are recognised as a separate component of equity.

On consolidation, exchange differences arising from the translation of the net investment in foreign operations, and of borrowings and other currency instruments designated as hedges of such investments, are taken to shareholders’ equity. When a foreign operation is sold, exchange differences that were recorded in equity are recognised in the income statement as part of the gain or loss on sale.

Goodwill and fair value adjustments arising on the acquisition of a foreign entity are treated as assets and liabilities of the foreign entity and translated at the closing rate.

4.4 *Property, plant and equipment*

Buildings comprise mainly factories and offices. All property, plant and equipment are stated at historical cost less accumulated depreciation. Historical cost includes expenditure that is directly attributable to the acquisition of the items.

Subsequent costs are included in the asset's carrying amount or recognised as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the CNAC Group and the cost of the item can be measured reliably. Costs of regular major checks and overhauls are capitalised and amortised over the maintenance cycle. All other repairs and maintenance are expensed in the income statement during the financial period in which they are incurred.

Depreciation on property, plant and equipment is calculated using the straight-line method to allocate their cost to their residual values over their estimated useful lives, as follows:

Buildings	20 to 30 years
Leasehold improvement	6 years
Aircraft and engines	10 to 20 years
Flight equipment and rotatable spares	7 to 20 years
Machinery, other equipment, furniture and motor vehicles	3 to 20 years

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

Where the carrying amount of an asset is greater than its estimated recoverable amount, it is written down immediately to its recoverable amount.

Gains and losses on disposals are determined by comparing proceeds with carrying amount. These are included in the income statement.

4.5 *Land use right*

Land use right represents operating lease prepayment for land less accumulated amortisation and impairment losses. Amortisation is calculated using the straight-line method to allocate the cost of operating lease prepayment for land over the remaining lease term.

4.6 *Intangible assets*

(a) Goodwill

Goodwill represents the excess of the cost of an acquisition over the fair value of the CNAC Group's share of the net identifiable assets of the acquired subsidiaries/ associates/jointly controlled entities at the date of acquisition. Goodwill on acquisitions of subsidiaries and jointly controlled entities is included in intangible assets. Separately recognised goodwill on acquisitions of associates is included in interests in associates. Goodwill is carried at cost less accumulated impairment losses. Impairment losses on goodwill are not reversed. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

Until 31 December 2004, goodwill was amortised using the straight-line method over its estimated useful life or not more than 20 years and assessed for an indication of impairment at balance sheet date. From 1 January 2005 onwards, goodwill is not subject to amortisation and is tested annually for impairment.

Goodwill is allocated to cash-generating units for the purpose of impairment testing. Each of those cash-generating units represents the CNAC Group's investment in operation of each country by each primary reporting segment (note 4.7).

(b) Trademark

Trademark is shown at historical cost. Trademark has a definite useful life and is carried at cost less accumulated amortisation. Amortisation is calculated using the straight-line method to allocate the cost of trademark over its estimated useful life.

4.7 *Impairment of non-financial assets*

Assets that have an indefinite useful life are not subject to amortisation and are tested annually for impairment and are reviewed for impairment. Assets that are subject to amortisation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating units). Non-financial assets other than goodwill that suffered an impairment are reviewed for possible reversal of the impairment at each reporting date.

4.8 *Financial assets*

From 1 January 2003 to 31 December 2004, the CNAC Group classified its investment in securities, other than subsidiaries, jointly controlled entities and associates, as non-trading investment securities.

Investment securities were stated at cost less provision for diminution in value other than temporary in nature.

From 1 January 2005 onwards, the CNAC Group classifies its investments into: loans and receivables and available-for-sale investments. The classification depends on the purpose for which the investments were acquired. Management determines the classification of its investments at initial recognition and re-evaluates this designation at every reporting date.

(a) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They are included in current assets, except for maturities greater than 12 months after the balance sheet date. These are classified as non-current assets.

(b) Available-for-sale investments

Available-for-sale investments are non-derivative financial assets that are designated as available for sale or are not classified as loans and receivables, held-to-maturity investments or financial assets at fair value through profit or loss.

Regular purchases and sales of investments are recognised on trade date – the date on which the CNAC Group commits to purchase or sell the asset. Investments are initially recognised at fair value plus transaction costs for all financial assets not carried at fair value through profit or loss. Investments are derecognised when the rights to receive cash flows from the investments have expired or have been transferred and the CNAC Group has transferred substantially all risks and rewards of ownership. Available-for-sale investments are subsequently carried at fair value. Loans and receivables are carried at amortised cost using the effective interest method. When securities classified as available-for-sale are sold or impaired, the accumulated fair value adjustments are included in the income statement as gains or losses from investment securities.

The fair values of quoted investments are based on current bid prices. If the market for a financial asset is not active (and for unlisted securities), the CNAC Group establishes fair value by using valuation techniques. These include the use of recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis, and option pricing models refined to reflect the issuer's specific circumstances.

The CNAC Group assesses at each balance sheet date whether there is objective evidence that a financial asset or a group of financial assets is impaired. In the case of equity securities classified as available for sale, a significant or prolonged decline in the fair value of the security below its cost is considered an indicator that the securities are impaired. If any such evidence exists for available-for-sale investments, the cumulative loss – measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that financial asset previously recognised in the income statement – is removed from equity and recognised in the income statement. Impairment losses recognised in the income statement on equity instruments are not reversed through the income statement. Impairment testing of trade receivables is described in note 4.10.

4.9 *Inventories*

Inventories comprise expendable spare parts and supplies, are stated at the lower of cost and net realisable value, and are expensed when used in operations. Cost is calculated on the average cost basis except for aircraft spare parts, cost of which is calculated on the first-in-first-out basis. Net realisable value is the estimated selling price in the ordinary course of business, less applicable variable selling expenses.

4.10 *Trade and other receivables*

Trade and other receivables are recognised initially at fair value and subsequently measured at amortised cost using the effective interest method, less provision for impairment. A provision for impairment of trade and other receivables is established when there is objective evidence that CNAC will not be able to collect all amounts due according to the original terms of receivables. Significant financial difficulties of the debtor, probability that the debtor will enter bankruptcy or financial reorganisation, and default or delinquency in payments are considered indicators that the trade receivables is impaired. The amount of the provision is the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the effective interest rate. The amount of the provision is recognised in the income statement.

4.11 *Manufacturers' credits*

Manufacturers' credits received in connection with leasing of aircraft, which the CNAC Group can apply those credits to reduce future costs of acquiring aircraft spares or rental payments, are either deferred and amortised as income or as a reduction of rental expenses for aircraft over relevant leases.

4.12 *Cash and cash equivalents*

Cash and cash equivalents include cash in hand, deposits held at call with banks, other short-term highly liquid investments with original maturities of three months or less.

4.13 *Borrowings*

Borrowings are recognised initially at fair value, net of transaction costs incurred. Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability, including fees and commissions paid to agents, advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Borrowings are subsequently stated at amortised cost; any difference between the proceeds (net of transaction costs) and the redemption value is recognised in the income statement over the period of the borrowings using the effective interest method.

4.14 *Deferred income tax*

Deferred income tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. However, the deferred income tax is not accounted for if it arises from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss. Deferred income tax is determined using tax rates (and laws) that have been enacted or substantially enacted by the balance sheet date and are expected to apply when the related deferred income tax asset is realised or the deferred income tax liability is settled.

Deferred income tax assets are recognised to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilised.

Deferred income tax is provided on temporary differences arising on investments in subsidiaries, associates and jointly controlled entities, except where the timing of the reversal of the temporary difference is controlled by the CNAC Group and it is probable that the temporary difference will not reverse in the foreseeable future.

4.15 *Employee benefits*

(i) Employee leave entitlements

Employee entitlements to annual leave are recognised when they accrue to employees of the CNAC Group. A provision is made for the estimated liability for annual leave as a result of services rendered by employees up to the balance sheet date.

Employee entitlements to sick leave and maternity or paternity leave are not recognised until the time of leave.

(ii) Retirement benefit costs

Contributions to the defined contribution schemes are charged to the income statement in the year in which the contributions relate.

(iii) Share-based compensation

The CNAC Group operates an equity-settled share-based compensation plan. The fair value of the employee services received in exchange for the grant of the options is recognised as an expense. The total amount to be expensed over the vesting period is determined by reference to the fair value of the options granted, excluding the impact of any non-market vesting conditions (for example, profitability and sales growth targets). Non-market vesting conditions are included in assumptions about the number of options that are expected to become exercisable. At each balance sheet date, the entity revises its estimates of the number of options that are expected to become exercisable. It recognises the impact of the revision of original estimates, if any, in the income statement, with a corresponding adjustment to equity over the remaining vesting period.

The proceeds received net of any directly attributable transaction costs are credited to share capital (nominal value) and share premium when the options are exercised.

(iv) Housing allowances

A jointly controlled entity of the CNAC Group makes payments to certain of its eligible employees related to an one-off adjustment made to the housing benefits of these eligible employees as of 31 October 2005. The amount of the related obligation is re-measured annually by an independent qualified actuary using the projected unit credit method. Actuarial gains and losses arising from experience adjustments, and changes in actuarial assumptions, are recognised in the current period.

4.16 Provisions

Provisions are recognised when the CNAC Group has a present legal or constructive obligation as a result of past events; it is more likely than not that an outflow of resources will be required to settle the obligation; and the amount has been reliably estimated. Provisions are not recognised for future operating losses.

Where there are a number of similar obligations, the likelihood that an outflow will be required in settlement is determined by considering the class of obligations as a whole. A provision is recognised even if the likelihood of an outflow with respect to any one item included in the same class of obligations may be small.

4.17 Provision for overhaul and major checks

A provision is made for the estimated costs of major checks and overhauls required to be conducted to fulfill the requirements under the relevant leases based on the maintenance cycle of each aircraft under operating leases.

4.18 Contingent liabilities

A contingent liability is a possible obligation that arises from past events and whose existence will only be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the CNAC Group. It can also be a present obligation arising from past events that is not recognised because it is not probable that outflow of economic resources will be required or the amount of obligation cannot be measured reliably.

A contingent liability is not recognised but is disclosed in the notes to the financial information. When a change in the probability of an outflow occurs so that outflow is probable, it will then be recognised as a provision.

4.19 Revenue recognition

Revenue comprises the fair value for the sale of goods and services, net of value-added tax, rebates and discounts and after eliminating sales within the CNAC Group. Ticket sales for transportation not yet provided are included in current liabilities as sales in advance of carriage. Revenues are recognised as follows:

(i) Passenger, cargo and mail revenues

Passenger, cargo and mail revenues are recognised when the transportation is provided.

(ii) Sale of goods

Revenue, net of sales discounts, from the sale of goods is recognised on the transfer of risks and rewards of ownership, which generally coincides with the time of delivery.

(iii) Inflight sales commission

Inflight sales commission is recognised when services are rendered.

(iv) Rental income

Rental income is recognised on a straight-line basis over the terms of the leases.

(v) Dividend income

Dividend income is recognised when the right to receive payment is established.

4.20 *Leases*

Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating leases (net of any incentives received from the lessor) are expensed in the income statement on a straight-line basis over the period of the lease.

4.21 *Borrowing costs*

Borrowing costs that are directly attributable to the acquisition, construction or production of an asset that necessarily takes a substantial period of time to get ready for its intended use or sale are capitalised as part of the cost of that asset.

All other borrowing costs are charged to the income statement in the period in which they are incurred.

4.22 *Dividend distribution*

Dividend distribution to CNAC's equity holders is recognised as a liability in the CNAC Group's financial statements in the period in which the dividends are approved by CNAC's equity holders.

4.23 *Accounting for derivative financial instruments*

Derivative financial instruments are designated 'hedging' or 'non-hedging instruments'. The transactions that, according to the CNAC Group's policy for risk management, are able to meet the conditions for hedge accounting are classified as hedging transactions; the others, although set up for the purpose of managing risk (since the CNAC Group's policy does not permit speculative transactions), have been designated as 'non-hedging'.

From 1 January 2003 to 31 December 2004:

The CNAC Group records derivative financial instruments at cost. The gains and losses on derivative financial instruments are included in the income statement on maturity to match the underlying hedged transactions where relevant.

From 1 January 2005 onwards:

Derivatives are initially recognised at fair value on the date a derivative contract is entered into and are subsequently remeasured at their fair value. Changes in the fair value of any derivative instruments that do not qualify for hedge accounting are recognised immediately in the income statement within 'other gains'.

5. **Critical accounting estimates and judgements**

Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

The CNAC Group makes estimates and assumptions concerning the future. The resulting accounting estimates will, by definition, seldom equal the related actual results. The estimates and assumptions that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are discussed below.

(i) *Impairment of goodwill*

The CNAC Group tests annually whether goodwill has suffered any impairment, in accordance with the accounting policy stated in note 4.6(a). The recoverable amounts of cash-generating units have been determined based on value-in-use calculations. These calculations require the use of estimates (note 18).

(ii) *Provision for overhaul and major checks*

The CNAC Group is required to perform relevant overhaul on engines and cycle checks on airframes during the lease period in order to fulfil certain requirements under the corresponding lease agreements and accordingly, provision is made for overhaul and major checks. The provision is made based on the estimated major checks and overhaul costs to completion over the proportion of monthly flying hours to remaining flying hours of the maintenance cycle. Significant judgment is required in determining the estimated major check costs and overhaul costs and the total flying hours in the maintenance cycle.

(iii) *Provision for housing allowances*

A jointly controlled entity provides cash allowances to its employees pursuant to a staff housing policy adopted during the year. The expected cost of providing these deferred housing allowances is calculated by an independent qualified actuary using the projected unit credit method, which involves a number of actuarial assumptions including the discount rate and employees' turnover rate before retirement.

6. Financial risk management

In the normal course of business, the CNAC Group is exposed to a variety of financial risks, including the effects of movements in foreign exchange rates, interest rates and jet fuel prices, insurance coverage risk and credit risk. These exposures are managed, sometimes with the use of derivative financial instruments.

(a) *Foreign currency risk*

The CNAC Group generates a portion of its venture from sales in certain foreign jurisdictions giving rise to exposures to risk from changes in foreign exchange rates. The currencies giving rise to this risk are primarily Taiwanese Dollars. The CNAC Group continuously monitors its foreign currency positions and does not consider that it has a significant exposure to risk from any currency.

The CNAC Group uses derivative financial instruments to hedge its exposure to foreign exchange risks arising from operational activities. In accordance with its treasury policy, the CNAC Group does not hold or issue derivative financial instruments for trading purpose.

(b) *Interest rate risk*

The CNAC Group did not have significant bank loans at the balance sheet date. Deposits placed with banks earn interest rates ranging from 0.001% to 4.15% per annum. The CNAC Group does not consider that it has a significant exposure to interest rate risk.

(c) *Fuel price risk*

In the normal course of business, the CNAC Group is exposed to fluctuations in jet fuel prices. At 31 December 2003, 2004 and 2005, the CNAC Group had one, two and six derivative contracts outstanding respectively to lock in future fuel price at a certain range. The CNAC Group receives from the counter-party the applicable difference between the fuel price and the strike price, subject to a cap, for the notional quantity if the fuel price rises above the strike price. In return, the CNAC Group pays the counter-party the difference between the fuel price and the strike price if the fuel price falls below the strike price.

The CNAC Group does not anticipate any material adverse effect on its financial position resulting from its involvement in this instrument, nor does it anticipate non-performance by any of its counter-party.

(d) Insurance coverage risk

A commercial airline is required to have adequate liability insurance cover. Following the "911" event, certain airlines have difficulties in securing adequate liability insurance cover. The CNAC Group is able to obtain the required liability insurance cover with increased premium rates. Part of the increased insurance charge is recovered from passengers through a surcharge.

(e) Credit risk

It is the CNAC Group's policy to obtain certain collateral from customers and counterparties who require credit. Management has a credit policy in place and the exposure to credit risk is monitored on an ongoing basis. At 31 December 2003, 2004 and 2005, there was no significant concentration of credit risk. The maximum exposure to credit risk is represented by the carrying amount of each financial asset in the balance sheet.

(f) Fair value

There were no material differences between the carrying amounts and estimated fair values of the CNAC Group's significant financial assets and liabilities at 31 December 2003, 2004 and 2005.

7. Revenues and segment information

Revenues recognised are as follows:

	Year ended 31 December		
	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000
Turnover			
Traffic revenues			
– Passenger services	984,211	1,355,391	1,544,125
– Cargo and mail services	242,820	516,372	807,259
Airline catering revenue	–	18,947	268,649
	<u>1,227,031</u>	<u>1,890,710</u>	<u>2,620,033</u>
Other revenues			
Inflight sales commission	1,861	3,136	5,453
Rental from sub-lease of aircraft	14,460	9,855	41,532
	<u>16,321</u>	<u>12,991</u>	<u>46,985</u>
Total revenues	<u>1,243,352</u>	<u>1,903,701</u>	<u>2,667,018</u>

The CNAC Group, its jointly controlled entities and its associates are organised into four main business segments including airline operation, airport ground handling, airline catering, logistics and other businesses.

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Primary reporting format – Business segments

	Year ended and at 31 December 2003				Total HK\$'000
	Airline operation HK\$'000	Airport ground handling HK\$'000	Airline catering HK\$'000	Logistics and other businesses HK\$'000	
Segment revenues	<u>1,243,352</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>1,243,352</u>
Segment results	<u>(193,390)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(193,390)</u>
Interest income					9,172
Unallocated costs					<u>(39,365)</u>
Operating loss					<u>(223,583)</u>
Finance costs					-
Share of profits less losses of associates	32,102	84,152	-	(9,564)	<u>106,690</u>
Loss before income tax					<u>(116,893)</u>
Income tax					<u>30,188</u>
Loss for the year					<u><u>(86,705)</u></u>
Segment assets	931,323	-	-	-	931,323
Interests in associates	1,118,216	97,711	-	(17,915)	1,198,012
Loans to associates	-	34,560	-	47,543	82,103
Unallocated assets					<u>1,155,070</u>
Total assets					<u><u>3,366,508</u></u>
Segment liabilities	477,442	-	-	-	477,442
Unallocated liabilities					<u>4,865</u>
Total liabilities					<u><u>482,307</u></u>
Capital expenditure	27,467	-	-	-	27,467
Depreciation	68,519	-	-	-	68,519
Amortisation	138	-	-	-	138
Reversal of provision for impairment of trade receivables	<u>(1,252)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(1,252)</u>

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	Year ended and at 31 December 2004				Total HK\$'000
	Airline operation HK\$'000	Airport ground handling HK\$'000	Airline catering HK\$'000	Logistics and other businesses HK\$'000	
Segment revenues	<u>1,884,754</u>	<u>-</u>	<u>18,947</u>	<u>-</u>	<u>1,903,701</u>
Segment results	<u>52,791</u>	<u>-</u>	<u>803</u>	<u>-</u>	<u>53,594</u>
Interest income					4,891
Unallocated costs					<u>(41,752)</u>
Operating profit					16,733
Finance costs					(375)
Share of profits less losses of associates	275,547	122,915	44	(8,056)	<u>390,450</u>
Profit before income tax					406,808
Income tax					<u>(12,344)</u>
Profit for the year					<u>394,464</u>
Segment assets	1,093,645	-	479,918	-	1,573,563
Interests in associates	1,391,299	106,722	115,114	(22,977)	1,590,158
Loans to associates	-	34,560	-	47,543	82,103
Unallocated assets					<u>689,437</u>
Total assets					<u>3,935,261</u>
Segment liabilities	559,319	-	134,386	-	693,705
Unallocated liabilities					<u>5,056</u>
Total liabilities					<u>698,761</u>
Capital expenditure	38,251	-	127,584	-	165,835
Depreciation	64,740	-	1,266	-	66,006
Amortisation	45	-	1,269	-	1,314
Provision for impairment of trade receivables	<u>1,175</u>	<u>-</u>	<u>235</u>	<u>-</u>	<u>1,410</u>

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	Year ended and at 31 December 2005				Total HK\$'000
	Airline operation HK\$'000	Airport ground handling HK\$'000	Airline catering HK\$'000	Logistics and other businesses HK\$'000	
Segment revenues	<u>2,398,369</u>	<u>–</u>	<u>268,649</u>	<u>–</u>	<u>2,667,018</u>
Segment results	<u>(51,954)</u>	<u>–</u>	<u>1,789</u>	<u>–</u>	<u>(50,165)</u>
Interest income					20,159
Unallocated costs					<u>(22,311)</u>
Operating loss					(52,317)
Finance costs					(2,960)
Share of profits less losses of associates	130,062	139,591	11,097	(3,507)	<u>277,243</u>
Profit before income tax					221,966
Income tax					<u>(10,042)</u>
Profit for the year					<u>211,924</u>
Segment assets	1,168,150	–	488,620	–	1,656,770
Interests in associates	1,365,917	165,445	122,178	(25,946)	1,627,594
Loans to associates	–	18,060	–	47,097	65,157
Unallocated assets					<u>867,522</u>
Total assets					<u>4,217,043</u>
Segment liabilities	741,313	–	115,658	–	856,971
Unallocated liabilities					<u>6,883</u>
Total liabilities					<u>863,854</u>
Capital expenditure	45,145	–	9,155	–	54,300
Depreciation	66,696	–	11,435	–	78,131
Amortisation	9	–	81	–	90
Provision for/(reversal of) impairment of trade receivables	<u>3,599</u>	<u>–</u>	<u>(147)</u>	<u>–</u>	<u>3,452</u>

Amortisation charge by business segments did not include goodwill arising from acquisitions of China National Aviation Corporation (Macau) Company Limited (“CNAC Macau”) of HK\$18,840,000 for the years ended 31 December 2003 and 2004 as the Directors consider that there is no meaningful basis for allocating such amortisation of goodwill between airline operation and airport ground handling businesses.

Secondary reporting format – Geographical segments

The CNAC Group and its jointly controlled entities operate in three main geographical areas including China mainland, Taiwan and other regions (mainly Macau, Thailand and Philippines). The airline operation business is mainly operated in places in China mainland, Taiwan and other regions. The airline catering business is operated in China mainland.

	Year ended 31 December					
	Segment revenues			Segment results		
	2003	2004	2005	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000
China mainland	489,377	772,856	1,223,674	(106,745)	(26,144)	(112,269)
Taiwan	651,251	1,025,639	1,301,998	(9,838)	134,486	140,221
Other regions	102,724	105,206	141,346	(76,807)	(54,748)	(78,117)
Total	<u>1,243,352</u>	<u>1,903,701</u>	<u>2,667,018</u>	(193,390)	53,594	(50,165)
Interest income				9,172	4,891	20,159
Unallocated costs				(39,365)	(41,752)	(22,311)
Operating (loss)/profit				<u>(223,583)</u>	<u>16,733</u>	<u>(52,317)</u>

The major revenue-earning assets of the CNAC Group are its aircraft fleet, all of which are registered in Macau. Since the CNAC Group's aircraft fleet is deployed flexibly across its route network, the Directors consider that there is no meaningful basis to allocating such assets to geographical segments.

The assets and capital expenditure of jointly controlled entities in respect of airline catering business are located in China mainland.

The assets and capital expenditure of the CNAC Group, other than those of jointly controlled entities and its aircraft fleet as mentioned in the above, are mainly located in Macau.

8. Other gains

	Year ended 31 December		
	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000
Derivative instruments	798	5,156	19,109
Interest income	9,172	4,891	20,159
	<u>9,970</u>	<u>10,047</u>	<u>39,268</u>

9. Staff costs

	Year ended 31 December		
	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000
Wages and salaries (including Directors' emoluments) (note (a))	211,345	248,528	324,664
Pension costs – defined contribution plans (note (b))	4,065	1,258	18,674
Housing allowances (note (c))	–	–	45,311
	<u>215,410</u>	<u>249,786</u>	<u>388,649</u>

(a) *Options*

Total staff costs for each of the years ended 31 December 2003, 2004 and 2005 (the “Relevant Periods”) do not include the amounts of benefits in kind provided to CNAC’s Directors in respect of CNAC’s Options being granted. Details of CNAC’s Options are set out in note 28(a) to the financial information.

(b) *Pension costs – Defined contribution plans*

CNAC contributes to the mandatory provident fund scheme (“MPF Scheme”) established under the Hong Kong Mandatory Provident Fund Scheme Ordinance which is available to eligible employees in Hong Kong.

The subsidiary in Macau operates defined contribution pension plans which are available to eligible employees. The assets of the plans are held separately from the subsidiary in independently administrated funds. Monthly contributions made by the subsidiary are calculated based on certain percentages of the applicable payroll costs or fixed sums as stipulated under the relevant requirements, as appropriate.

The jointly controlled entities in China mainland participate in defined contribution retirement schemes organised by the municipal governments of the provinces in which the jointly controlled entities operate.

The retirement benefit costs represent gross contributions paid and payable to the MPF Scheme in Hong Kong, the defined contribution pension plans in Macau and defined contribution retirement schemes in China mainland (collectively the “Retirement Schemes”). Contributions totalling HK\$3,394,000, HK\$2,502,000 and HK\$2,215,000 payable to the Retirement Schemes are included in trade and other payables at 31 December 2003, 2004 and 2005 respectively. Forfeited contribution totalling HK\$927,000, HK\$1,490,000 and HK\$1,553,000 were utilised respectively during the years ended 31 December 2003, 2004 and 2005 leaving HK\$51,000 available at 31 December 2003 and no balance available at 31 December 2004 and 2005 to reduce future contributions.

(c) *Housing allowances*

During the year ended 31 December 2005, Beijing Air Catering Co., Ltd. (“BACL”), a jointly controlled entity of the CNAC Group, approved a staff housing policy (the “Staff Housing Policy”), pursuant to which those eligible employees as of 31 October 2005 who have not been allocated with any housing quarters or been allocated with housing quarters below the standard specified in the Staff Housing Policy were entitled to an one-off cash payment, which vests and is paid over a 10-year payment period. If an eligible employee leaves, for any reason other than normal retirement, during this period, the related obligation is forfeited. The amount of the one-off cash payment is calculated based on an eligible employee’s years of services, position and other criteria as set out in the Staff Housing Policy. A liability has been established based on the actuarially determined obligation arising pursuant to the Staff Housing Policy.

(d) *Directors' emoluments*

The remuneration of each Director during the Relevant Periods is set out below:

Name	Fees HK\$'000	Other benefits HK\$'000	Total HK\$'000
For the year ended 31 December 2003			
<i>Executive Directors:</i>			
Kong Dong	–	2,050	2,050
Chuang Shih Ping	–	13,649	13,649
Zhang Xianlin	–	14,965	14,965
Tsang Hing Kwong, Thomas	61	14,715	14,776
Gu Tiefei	61	2,387	2,448
	<u>122</u>	<u>47,766</u>	<u>47,888</u>
<i>Independent non-executive Directors:</i>			
Lok Kung Nam	20	–	20
Hu Hung Lick, Henry	20	–	20
Ho Tsu Kwok, Charles	20	–	20
Li Kwok Heem, John	20	–	20
	<u>80</u>	<u>–</u>	<u>80</u>
	<u>202</u>	<u>47,766</u>	<u>47,968</u>
For the year ended 31 December 2004			
<i>Executive Directors:</i>			
Kong Dong	–	2,050	2,050
Chuang Shih Ping	–	385	385
Zhang Xianlin	–	1,701	1,701
Zhao Xiaohang	–	547	547
Tsang Hing Kwong, Thomas	466	1,532	1,998
Gu Tiefei	70	385	455
	<u>536</u>	<u>6,600</u>	<u>7,136</u>
<i>Independent non-executive Directors:</i>			
Lok Kung Nam	40	–	40
Hu Hung Lick, Henry	40	–	40
Ho Tsu Kwok, Charles	40	–	40
Li Kwok Heem, John	40	–	40
Chan Ching Har, Eliza	14	–	14
	<u>174</u>	<u>–</u>	<u>174</u>
	<u>710</u>	<u>6,600</u>	<u>7,310</u>

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Name	Fees HK\$'000	Other benefits HK\$'000	Total HK\$'000
For the year ended 31 December 2005			
<i>Executive Directors:</i>			
Kong Dong	–	2,050	2,050
Chuang Shih Ping	–	385	385
Zhang Xianlin	–	1,702	1,702
Zhao Xiaohang	–	937	937
Tsang Hing Kwong, Thomas	466	1,532	1,998
Gu Tiefei	70	385	455
	<u>536</u>	<u>6,991</u>	<u>7,527</u>
<i>Independent non-executive Directors:</i>			
Lok Kung Nam	60	–	60
Hu Hung Lick, Henry	60	–	60
Ho Tsu Kwok, Charles	60	–	60
Li Kwok Heem, John	60	–	60
Chan Ching Har, Eliza	60	–	60
	<u>300</u>	<u>–</u>	<u>300</u>
	<u>836</u>	<u>6,991</u>	<u>7,827</u>

Benefits in kind for the year ended 31 December 2003 included the aggregate fair value of the Options granted to Chuang Shih Ping, Zhang Xianlin, Tsang Hing Kwong, Thomas and Gu Tiefei of approximately HK\$13,264,000, HK\$13,264,000, HK\$13,264,000 and HK\$2,002,000 respectively under CNAC's Share Option Scheme (note 28(a)) which had not been accounted for in the CNAC Group's financial statements pursuant to the transitional provisions of HKFRS 2. CNAC did not grant any Options during the years ended 31 December 2004 and 2005.

(e) *Five highest paid individuals*

The five individuals whose emoluments were the highest in the CNAC Group for the year ended 31 December 2003 include five Directors and, for the years ended 31 December 2004 and 2005, include three Directors whose emoluments are set out in note 9(d) above. The emoluments payable to the remaining two individuals during the years ended 31 December 2004 and 2005 are as follows:

	Year ended 31 December		
	2003 HK\$'000	2004 HK\$'000	2005 HK\$'000
Wages, salaries and allowances	–	3,059	3,108
Pension costs – defined contribution plans	–	155	207
	<u>–</u>	<u>3,214</u>	<u>3,315</u>

The emoluments of the employees fell within the following bands:

	Number of individuals		
	2003	2004	2005
Emolument bands			
HK\$1,000,001 – HK\$1,500,000	–	1	1
HK\$1,500,001 – HK\$2,000,000	–	1	1
	<u>–</u>	<u>2</u>	<u>2</u>

During the Relevant Periods, the CNAC Group did not pay to the Directors or the five highest paid individuals any inducement to join or upon joining the CNAC Group, or as compensation for loss of office. No Directors waived or agreed to waive any emoluments during the Relevant Periods.

10. Operating (loss)/profit

The following items have been included in arriving at operating (loss)/profit:

	Year ended 31 December		
	2003 HK\$'000	2004 HK\$'000	2005 HK\$'000
Crediting			
Gain on disposal of property, plant and equipment	–	–	41
Gain on disposal of an available-for-sale investment	–	–	1,207
Reversal of provision for impairment of trade receivables	1,252	–	–
Write-back of payables	–	–	1,794
Amortisation of manufacturers' credits	7,600	1,393	1,388
Net exchange gains	349	6,474	–
	<u> </u>	<u> </u>	<u> </u>
Charging			
Amortisation of intangible assets	18,978	20,144	9
Amortisation of land use right	–	10	81
Auditors' remuneration	1,312	1,275	1,710
Cost of inventories expensed	43,560	38,681	147,206
Depreciation of property, plant and equipment	68,519	66,006	78,131
Loss on disposal of property, plant and equipment	458	334	–
Operating lease rentals			
– Aircraft and related equipments	332,340	374,580	471,833
– Buildings	20,226	20,298	19,601
Provision for impairment of trade receivables	–	1,410	3,452
Provision for overhaul and major checks costs (note 30)	95,658	84,772	138,427
Net exchange losses	–	–	5,162
	<u> </u>	<u> </u>	<u> </u>

11. Finance costs

	Year ended 31 December		
	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000
Interest expenses on short-term bank loans	–	375	2,960
	<u> </u>	<u> </u>	<u> </u>

12. Income tax

Hong Kong profits tax has been provided at the rate of 17.5% on the estimated assessable profits for the Relevant Periods. On 7 July 2005, the Macau Legislative Assembly approved Law No. 4/2005 to reduce the Macau Complementary Tax rate from 15.75% to 12%, accordingly the Macau Complementary Tax has been provided at rates of 15.75%, 15.75% and 12% on the estimated assessable profits for the years ended 31 December 2003, 2004 and 2005 respectively.

The CNAC Group has two jointly controlled entities in China mainland, namely BACL and Southwest Air Catering Company Limited (“SWACL”) which were acquired during the year ended 31 December 2004. Pursuant to the Circular (2001) No. 202 issued by the Ministry of Finance, State Administration of Taxation and General Administration of Customs, SWACL is subject to a reduced income tax rate of 15% for the years from 2001 to 2010. BACL is subject to the income tax rate of 27% for the two years ended 31 December 2004 and 2005.

Taxation outside Hong Kong and Macau has been calculated on the estimated assessable profits for the Relevant Periods at the rates of taxation prevailing in the countries in which the CNAC Group operates.

	Year ended 31 December		
	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000
Current income tax			
– Taxation outside Hong Kong and Macau	613	1,308	11,700
– Over provisions in prior years	(468)	(5)	(8)
Deferred income tax (<i>note 34</i>)	(30,333)	11,041	(1,650)
	<u> </u>	<u> </u>	<u> </u>
Income tax	<u>(30,188)</u>	<u>12,344</u>	<u>10,042</u>

Share of taxation of associates amounting to HK\$16,501,000, HK\$79,202,000 and HK\$29,437,000 are included in the consolidated income statement as share of profits less losses of associates for the years ended 31 December 2003, 2004 and 2005 respectively.

The income tax on the CNAC Group's (loss)/profit before income tax differs from the theoretical amount that would arise using the tax rates prevailing in Macau, where the CNAC Group's principal subsidiary operates, as follows:

	Year ended 31 December		
	2003 HK\$'000	2004 HK\$'000	2005 HK\$'000
(Loss)/profit before income tax	(116,893)	406,808	221,966
Calculated at the tax rate of 15.75% (2004: 15.75%; 2005: 12%)	(18,411)	64,072	26,636
Tax effect on share of associates' profit less losses	(16,804)	(61,496)	(33,269)
Effect of different taxation rates in other territories	318	945	547
Income not subject to taxation	(1,319)	(737)	(1,841)
Expenses not deductible for taxation purposes	2,993	3,197	556
Tax losses not recognised	3,525	3,926	8,208
Write down of tax losses previously recognised (note)	-	2,608	4,619
Over provision for taxation in prior years	(468)	(5)	(8)
Decrease in taxation resulting from a reduction in tax rate	-	-	4,594
Others	(22)	(166)	-
Income tax	<u>(30,188)</u>	<u>12,344</u>	<u>10,042</u>

Note:

The CNAC Group re-assessed the recoverability of deferred income tax assets. The carrying amount of deferred income tax assets was written down to the extent that it is not probable that future taxable profit would be available against which the tax losses previously recognised could be utilised prior to their expiry.

13. Profit attributable to equity holders of CNAC

The profit attributable to equity holders of CNAC is dealt with in the financial statements of CNAC to the extent of HK\$36,173,000, HK\$64,735,000 and HK\$203,468,000 for the years ended 31 December 2003, 2004 and 2005 respectively.

14. Dividends

	Year ended 31 December		
	2003 HK\$'000	2004 HK\$'000	2005 HK\$'000
Interim dividend, paid, of HK0.3 cent (2004: HK0.6 cent; 2005: HK0.8 cent) per share	9,938	19,876	26,501
Final dividend, proposed, of HK0.6 cent (2004: HK1.0 cent; 2005: HK1.0 cent) per share	19,876	33,127	33,127
Adjustment on 2002 final dividend due to the repurchase of shares	(53)	-	-
	<u>29,761</u>	<u>53,003</u>	<u>59,628</u>

15. (Loss)/earnings per Share

Basic

Basic (loss)/earnings per Share is calculated by dividing the (loss)/profit attributable to equity holders of CNAC by the weighted average number of shares in issue during the year.

	Year ended 31 December		
	2003 HK\$'000	2004 HK\$'000	2005 HK\$'000
(Loss)/profit attributable to equity holders of CNAC	<u>(17,295)</u>	<u>360,969</u>	<u>225,000</u>
Weighted average number of Shares in issue (thousands)	<u>3,314,824</u>	<u>3,312,680</u>	<u>3,312,680</u>
Basic (loss)/earnings per Share (HK cents per share)	<u>(0.52)</u>	<u>10.90</u>	<u>6.79</u>

Diluted

Diluted (loss)/earnings per Share is calculated based on the (loss)/profit attributable to the equity holders of CNAC and the weighted average number of Shares in issue during the year, after adjusting for the number of dilutive potential shares deemed to be issued at no considerations as if all outstanding Options granted by CNAC had been exercised.

	Year ended 31 December		
	2003 HK\$'000	2004 HK\$'000	2005 HK\$'000
(Loss)/profit attributable to the equity holders of CNAC	<u>(17,295)</u>	<u>360,969</u>	<u>225,000</u>
Weighted average number of Shares in issue (thousands)	3,314,824	3,312,680	3,312,680
Adjustment for assumed conversion of Options (thousands)	<u>–</u>	<u>28,068</u>	<u>35,844</u>
Weighted average number of Shares for diluted earnings per Share (thousands)	<u>3,314,824</u>	<u>3,340,748</u>	<u>3,348,524</u>
Diluted (loss)/earnings per Share (HK cents per share)	<u>(0.52)</u>	<u>10.81</u>	<u>6.72</u>

16. Property, plant and equipment

	CNAC Group					Total HK\$'000
	Buildings (notes (i) and (ii)) HK\$'000	Leasehold improvements HK\$'000	Aircraft and engines HK\$'000	Flight equipment and rotable spares HK\$'000	Machinery, other equipment, furniture and motor vehicles HK\$'000	
At 1 January 2003						
Cost	-	28,384	418,040	230,065	49,954	726,443
Accumulated depreciation	-	(22,924)	(105,277)	(125,380)	(31,728)	(285,309)
Net book amount	-	5,460	312,763	104,685	18,226	441,134
Year ended 31 December 2003						
Opening net book amount at 1 January 2003	-	5,460	312,763	104,685	18,226	441,134
Additions	-	2,598	-	15,887	8,982	27,467
Disposals	-	(24)	-	(604)	(76)	(704)
Depreciation	-	(1,350)	(31,849)	(29,542)	(5,778)	(68,519)
Closing net book amount at 31 December 2003	-	6,684	280,914	90,426	21,354	399,378
At 31 December 2003						
Cost	-	28,941	418,040	243,797	56,326	747,104
Accumulated depreciation	-	(22,257)	(137,126)	(153,371)	(34,972)	(347,726)
Net book amount	-	6,684	280,914	90,426	21,354	399,378
Year ended 31 December 2004						
Opening net book amount at 1 January 2004	-	6,684	280,914	90,426	21,354	399,378
Acquisition of jointly controlled entities (note 35(b))	87,393	-	-	-	37,668	125,061
Additions	13	1,229	12,160	3,868	21,139	38,409
Disposals	-	(597)	-	(158)	(301)	(1,056)
Depreciation	(534)	(1,465)	(31,809)	(23,246)	(8,952)	(66,006)
Closing net book amount at 31 December 2004	86,872	5,851	261,265	70,890	70,908	495,786
At 31 December 2004						
Cost	87,355	17,056	430,200	246,499	107,215	888,325
Accumulated depreciation	(483)	(11,205)	(168,935)	(175,609)	(36,307)	(392,539)
Net book amount	86,872	5,851	261,265	70,890	70,908	495,786

	CNAC Group						Total HK\$'000
	Buildings (notes (i) and (ii)) HK\$'000	Leasehold improvements HK\$'000	Aircraft and engines HK\$'000	Flight equipment and rotable spares HK\$'000	Machinery, other equipment, furniture, and motor vehicles HK\$'000	Construction- in-progress HK\$'000	
Year ended 31 December 2005							
Opening net book amount at 1 January 2005	86,872	5,851	261,265	70,890	70,908	-	495,786
Additions	286	1,285	25,029	15,708	10,177	1,815	54,300
Disposals	-	-	-	(131)	(132)	-	(263)
Depreciation	(5,786)	(1,577)	(31,681)	(23,354)	(15,733)	-	(78,131)
Closing net book amount at 31 December 2005	<u>81,372</u>	<u>5,559</u>	<u>254,613</u>	<u>63,113</u>	<u>65,220</u>	<u>1,815</u>	<u>471,692</u>
At 31 December 2005							
Cost	87,641	18,235	455,229	261,576	113,502	1,815	937,998
Accumulated depreciation	(6,269)	(12,676)	(200,616)	(198,463)	(48,282)	-	(466,306)
Net book amount	<u>81,372</u>	<u>5,559</u>	<u>254,613</u>	<u>63,113</u>	<u>65,220</u>	<u>1,815</u>	<u>471,692</u>

- (i) At 31 December 2004 and 2005, property, plant and equipment included buildings of net book amount of approximately HK\$40,763,000 and HK\$37,988,000 respectively relating to the buildings of BACL situated on pieces of allocated land held by a related party. Air China, the immediate holding company of CNAC, is procuring to transfer those land from the related party to Air China in order to ensure Air China will legally and/or beneficially own the interests and benefits of such land. Air China agrees that BACL can continue to use the land at nominal consideration until such time Air China obtains the legal title of the land. A lease agreement would then be entered into between Air China and BACL for a term of up to 30 April 2023 at a rent to be calculated on the basis of the original costs for obtaining such land use right. Accordingly, the Directors did not take into account any losses and costs arising from the inability to use any land currently used by BACL in the preparation of the financial information.

Air China has further agreed to complete, at its expense, the formal procedures for transferring the building ownership rights of part of the production facilities from Air China to BACL. Such part of the production facilities were agreed to be injected by Air China into BACL as part of its initial capital contribution when BACL was established. No lease agreement has been entered between BACL and Air China.

- (ii) At 31 December 2004 and 2005, property, plant and equipment included buildings of net book amount of approximately HK\$38,044,000 and HK\$39,866,000 respectively relating to an inflight meals production building held by SWACL which was put into use in 2004. However, SWACL was advised by Chengdu Shuangliu International Airport on 7 August 2003 that this inflight meals production building is situated in an area where the extension of airport premises will be located. As a result, this inflight meals production building might need to be demolished on or before 2015.

The Directors consider that this is only a suggestion proposed by Chengdu Shuangliu International Airport and so far SWACL has not received any formal notification from the relevant government authorities regarding this. Nevertheless, the Directors consider that SWACL had obtained all necessary approvals before constructing this production building and they are confident that SWACL is able to receive fair compensations from Chengdu Shuangliu International Airport should SWACL be requested to demolish the production building. The Directors consider that this matter is currently at a preliminary stage of development, accordingly, it is too early to consider any potential impact to SWACL and the CNAC Group.

17. Land use right

The CNAC Group's interests in land use right in China mainland represent operating lease prepayments for land with a lease term of 50 years. The movement of land use right during the Relevant Periods is as follows:

	CNAC Group		
	2003 HK\$'000	2004 HK\$'000	2005 HK\$'000
At 1 January	–	–	2,355
Acquisition of jointly controlled entities (<i>note 35(b)</i>)	–	2,365	–
Amortisation	–	(10)	(81)
	<u>–</u>	<u>2,355</u>	<u>(81)</u>
At 31 December	<u>–</u>	<u>2,355</u>	<u>2,274</u>

18. Intangible assets

	CNAC Group			Total HK\$'000
	Goodwill HK\$'000	Trademark HK\$'000	Others HK\$'000	
At 1 January 2003				
Cost	339,111	928	2,733	342,772
Accumulated amortisation	(14,130)	(928)	(2,541)	(17,599)
	<u>324,981</u>	<u>–</u>	<u>192</u>	<u>325,173</u>
Year ended 31 December 2003				
Opening net book amount				
at 1 January 2003	324,981	–	192	325,173
Amortisation	(18,840)	–	(138)	(18,978)
	<u>306,141</u>	<u>–</u>	<u>54</u>	<u>306,195</u>
At 31 December 2003				
Cost				
at 31 December 2003	339,111	928	2,733	342,772
Accumulated amortisation	(32,970)	(928)	(2,679)	(36,577)
	<u>306,141</u>	<u>–</u>	<u>54</u>	<u>306,195</u>
Net book amount				
at 31 December 2003	<u>306,141</u>	<u>–</u>	<u>54</u>	<u>306,195</u>

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	CNAC Group			Total HK\$'000
	Goodwill HK\$'000	Trademark HK\$'000	Others HK\$'000	
Year ended 31 December 2004				
Opening net book amount at 1 January 2004	306,141	–	54	306,195
Acquisition of jointly controlled entities (<i>note 35(b)</i>)	243,198	–	–	243,198
Amortisation	<u>(20,099)</u>	<u>–</u>	<u>(45)</u>	<u>(20,144)</u>
Closing net book amount at 31 December 2004	<u><u>529,240</u></u>	<u><u>–</u></u>	<u><u>9</u></u>	<u><u>529,249</u></u>
At 31 December 2004				
Cost	582,309	928	2,733	585,970
Accumulated amortisation	<u>(53,069)</u>	<u>(928)</u>	<u>(2,724)</u>	<u>(56,721)</u>
Net book amount	<u><u>529,240</u></u>	<u><u>–</u></u>	<u><u>9</u></u>	<u><u>529,249</u></u>
Year ended 31 December 2005				
Opening net book amount at 1 January 2005	529,240	–	9	529,249
Amortisation	<u>–</u>	<u>–</u>	<u>(9)</u>	<u>(9)</u>
Closing net book amount at 31 December 2005	<u><u>529,240</u></u>	<u><u>–</u></u>	<u><u>–</u></u>	<u><u>529,240</u></u>
At 31 December 2005				
Cost	529,240	–	–	529,240
Accumulated amortisation	<u>–</u>	<u>–</u>	<u>–</u>	<u>–</u>
Net book amount	<u><u>529,240</u></u>	<u><u>–</u></u>	<u><u>–</u></u>	<u><u>529,240</u></u>

Impairment tests for goodwill

Goodwill acquired through the business combinations has been allocated to the cash-generating unit ("CGU") within the business segments of airline operation, airport ground handling and airline catering.

The recoverable amount of CGU is determined based on value-in-use calculation. These calculations use cash flow projections based on actual financial results for the year ended 31 December 2005. Cash flows after one year up to the end of the franchise or joint venture periods are extrapolated using the estimated growth rates stated below.

Key assumptions used in the value-in-use calculation

	Airline operation	Airport ground handling	Airline catering
Growth rate	7%	4%	10%
Discount rate	10%	10%	10%

Management determined budgeted net margin based on the past performance and its expectations for the market development. The weighted average growth rates used are consistent with the industry forecasts. The discount rates used reflect specific risks relating to the relevant industry.

19. Interests in subsidiaries

	CNAC		
	At 31 December		
	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000
Unlisted shares, at cost	803,666	803,666	803,666
Amounts due from subsidiaries	714,674	1,178,194	1,211,154
Amounts due to subsidiaries	(216)	–	–
	<u>1,518,124</u>	<u>1,981,860</u>	<u>2,014,820</u>

The amounts due from/(to) subsidiaries are unsecured, interest free and have no fixed terms of repayment. The Directors have confirmed that they will not request for repayment of the amounts due to CNAC until such time as and when the subsidiaries are in a position to repay. Accordingly, the Directors classified these amounts due from subsidiaries as non-current assets

Details of the subsidiaries at 31 December 2003, 2004 and 2005 are set out below:

Name	Date of incorporation	Place of incorporation	Place of operation	Principal activities	Particulars of issued shares/capital	CNAC Group equity interest		
						2003	2004	2005
^{1,2} Air Macau Company Limited	13 September 1994	Macau	Macau	Airline operator	4,000,000 ordinary shares of MOP100 each	51%	51%	51%
² China National Aviation Corporation (Macau) Company Limited	27 July 1993	Macau	Macau	Investment holding	Quota capital of MOP10,000,000	100%	100%	100%
Skylink Global Limited	2 January 2002	British Virgin Islands	Hong Kong	Investment holding	10 ordinary shares of US\$1 each	100%	100%	100%
Fly Top Limited	2 March 2004	British Virgin Islands	Hong Kong	Investment holding	10 ordinary shares of US\$1 each	–	100%	100%
Kingston International Limited	1 December 1989	British Virgin Islands	Hong Kong	Investment holding	2 ordinary shares of US\$1 each	100%	100%	100%
Queenston International Limited	18 December 1989	British Virgin Islands	Hong Kong	Investment holding	2 ordinary shares of US\$1 each	100%	100%	100%
Serfil Limited	3 January 1989	British Virgin Islands	Hong Kong	Investment holding	1 ordinary share of US\$1	100%	100%	100%
Skyrise Limited	30 March 1994	British Virgin Islands	Hong Kong	Investment holding	1 ordinary share of US\$1	100%	100%	100%
Wington Limited	21 November 1989	British Virgin Islands	Hong Kong	Investment holding	1 ordinary share of US\$1	100%	100%	100%

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Name	Date of incorporation	Place of incorporation	Place of operation	Principal activities	Particulars of issued shares/capital	CNAC		
						Group equity interest		
						2003	2004	2005
China National Aviation Logistics Company Limited	3 November 2000	Hong Kong	Hong Kong	Investment holding	2 ordinary shares of HK\$10 each	100%	100%	100%
China National Aviation Technology Company Limited	26 April 2000	Hong Kong	Hong Kong	Investment holding	2 ordinary shares of HK\$10 each	100%	100%	100%
² China National Aviation CyberWorks Limited	28 June 2000	Bermuda	Hong Kong	Dormant	1,000,000 ordinary shares of HK\$0.1 each	100%	100%	100%

All subsidiaries are limited liability companies.

¹ Subsidiary not audited by PricewaterhouseCoopers, the net assets and turnover of which amounted to approximately 18% and 100% for the year ended 31 December 2003 (2004: 22% and 100%; 2005: 19% and 100%).

² Subsidiaries held indirectly by CNAC.

20. Interests in jointly controlled entities

The following amounts represent the CNAC Group's proportionate share of the assets, liabilities, revenues and expenses of the jointly controlled entities and are included in the consolidated balance sheet and income statement:

	At and for the year ended 31 December		
	2003 HK\$'000	2004 HK\$'000	2005 HK\$'000
Non-current assets	–	135,026	137,247
Current assets	–	102,955	112,206
	–	237,981	249,453
Non-current liabilities	–	–	(34,126)
Current liabilities	–	(134,386)	(88,647)
	–	(134,386)	(122,773)
Net assets	–	103,595	126,680
Revenues	–	18,947	268,649
Other gains	–	78	365
Operating expenses	–	(16,883)	(266,860)
Finance costs	–	(375)	(2,960)
Profit/(loss) before income tax	–	1,767	(806)
Income tax	–	(247)	(134)
Net profit/(loss)	–	1,520	(940)

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The following is a list of jointly controlled entities at 31 December 2003, 2004 and 2005:

Name	Place of establishment and operation	Principal activities	Percentage of interest in								
			Ownership			Voting power			Profit sharing		
			2003	2004	2005	2003	2004	2005	2003	2004	2005
Beijing Air Catering Co., Ltd.	PRC	Airline catering	-	60%	60%	-	56%	56%	-	60%	60%
Southwest Air Catering Company Limited	PRC	Airline catering	-	60%	60%	-	60%	60%	-	60%	60%

21. Interests in associates and loans to associates
(a) Interests in associates

	CNAC Group		
	2003 HK\$'000	2004 HK\$'000	2005 HK\$'000
At 1 January	1,162,514	1,198,012	1,590,158
Share of opening adjustments on adoption of HKAS 39	-	-	(19,023)
	<u>1,162,514</u>	<u>1,198,012</u>	<u>1,571,135</u>
Acquisition of an associate	-	115,069	-
Share of profits less losses	106,690	390,450	277,243
Dividends received	(69,535)	(110,960)	(246,187)
Share of deficit on revaluation of investment securities	(1,716)	(2,464)	-
Share of fair value gains of derivative financial instruments	-	-	25,319
Share of currency translation differences not realised in net profit	59	51	84
	<u>59</u>	<u>51</u>	<u>84</u>
At 31 December	<u>1,198,012</u>	<u>1,590,158</u>	<u>1,627,594</u>

Interests in associates above at 31 December 2004 and 2005 include goodwill of HK\$52,708,000. No goodwill was included in interests in associates at 31 December 2003.

The shares of Tradeport Hong Kong Limited, an associate, held by the CNAC Group were pledged as securities for a banking facility granted to the associate (note 37).

	CNAC		
	At 31 December		
	2003 HK\$'000	2004 HK\$'000	2005 HK\$'000
Unlisted shares, at cost	<u>51,789</u>	<u>51,789</u>	<u>51,789</u>

The financial information of the CNAC Group's interest in associates is set out as follows:

	At 31 December 2003		
	Dragonair HK\$'000	Others HK\$'000	Total HK\$'000
Assets	<u>4,631,659</u>	<u>351,313</u>	<u>4,982,972</u>
Liabilities	<u>3,513,443</u>	<u>271,517</u>	<u>3,784,960</u>
Revenues	<u>2,819,638</u>	<u>392,693</u>	<u>3,212,331</u>
Net profit	<u>32,102</u>	<u>74,588</u>	<u>106,690</u>
Dividends	<u>–</u>	<u>69,535</u>	<u>69,535</u>
	At 31 December 2004		
	Dragonair HK\$'000	Others HK\$'000	Total HK\$'000
Assets	<u>4,979,952</u>	<u>504,957</u>	<u>5,484,909</u>
Liabilities	<u>3,588,653</u>	<u>358,806</u>	<u>3,947,459</u>
Revenues	<u>3,932,712</u>	<u>576,310</u>	<u>4,509,022</u>
Net profit	<u>275,547</u>	<u>114,903</u>	<u>390,450</u>
Dividends	<u>–</u>	<u>110,960</u>	<u>110,960</u>
	At 31 December 2005		
	Dragonair HK\$'000	Others HK\$'000	Total HK\$'000
Assets	<u>4,815,526</u>	<u>555,995</u>	<u>5,371,521</u>
Liabilities	<u>3,449,609</u>	<u>347,026</u>	<u>3,796,635</u>
Revenues	<u>4,699,228</u>	<u>629,171</u>	<u>5,328,399</u>
Net profit	<u>130,061</u>	<u>147,182</u>	<u>277,243</u>
Dividends	<u>160,171</u>	<u>86,016</u>	<u>246,187</u>

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The following is a list of associates, all of which are unlisted, at 31 December 2003, 2004 and 2005:

Name	Place of incorporation and operation	Principal activities	Particulars of issued shares/capital	CNAC Group equity interest		
				2003	2004	2005
¹ Dragonair	Hong Kong	Airline operator	500,000,000 ordinary shares of HK\$1 each	43.29%	43.29%	43.29%
² LSG Lufthansa Service Hong Kong Limited	Hong Kong	Airline catering	501 ordinary shares of HK\$1 each	-	20.20%	20.20%
Jardine Airport Services Limited	Hong Kong	Airport ground handling services	1,000 ordinary shares of HK\$10 each	50.00%	50.00%	50.00%
² Tradeport Hong Kong Limited	Hong Kong	Development and operation of a logistic center	400 ordinary shares of HK\$1 each	25.00%	25.00%	25.00%
² Menzies Macau Airport Services Limited ("Menzies Macau")	Macau	Airport ground handling services	Quota capital of MOP10,000,000	33.65%	33.65%	33.65%
² Macau Aircraft Repair and Conversion Company Limited	Macau	Aircraft repair and conversion	Quota capital of MOP100,000	25.05%	25.05%	25.05%

¹ 1.47% of the CNAC Group's equity interest in Dragonair is held directly by CNAC, while the remaining 41.82% is held indirectly through subsidiaries.

² Associates held indirectly by CNAC.

(b) *Loans to associates*

The loans to associates are mainly denominated in Hong Kong dollar and are unsecured, interest free and have no fixed terms of repayment. The Directors have confirmed that they will not request for repayment of the loans due to CNAC until such time as and when the associates are in a position to repay. Accordingly, the Directors classified these loans as non-current assets.

22. Loan to an associate

The loan to an associate is denominated in Hong Kong dollar and is unsecured, interest free and has no fixed terms of repayment.

23. Investment securities

	CNAC Group		
	At 31 December		
	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000
Unlisted investment	—	18,313	—

Unlisted investment represented BACL's equity investment of 10% in 國航集團財務有限公司 ("Finance Company"). Pursuant to a share transfer agreement entered into between BACL and CNAH in August 2004, BACL agreed to dispose of its investment in the Finance Company to CNAH at a consideration of RMB34,561,000 (equivalent to HK\$33,222,000). The disposal was completed in 2005.

24. Derivative financial instruments

	CNAC Group		
	At 31 December		
	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000
Fuel price forward and option contracts	—	—	11,957

At 31 December 2003, 2004 and 2005, the CNAC Group had one, two and six derivative contracts outstanding, respectively, to lock in future fuel price at a certain range. According to the contracts, the CNAC Group is entitled to receive from the counter-party the applicable difference between the fuel price and the strike price for the notional quantity if the fuel prices rises above the strike price and pay the counter-party the difference between the fuel price and the strike price if the fuel price falls below the strike price. These contracts will be expired before the year ending 31 December 2006. The derivative contracts were not accounted for in the consolidated balance sheets at 31 December 2003 and 2004 under the transitional provisions of HKAS 39.

25. Inventories

	CNAC Group		
	At 31 December		
	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000
Expendable spare parts and maintenance materials	40,870	41,205	40,071
Inflight/catering supplies	7,515	11,379	11,240
Others	2,439	1,461	1,962
	<u>50,824</u>	<u>54,045</u>	<u>53,273</u>

26. Trade and other receivables

	CNAC Group			CNAC		
	At 31 December			At 31 December		
	2003	2004	2005	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000
Trade receivables (notes a, c and d)	114,112	184,304	204,991	-	-	-
Due from (notes b and c):						
Immediate holding company	-	36,245	29,412	-	-	-
An associate	30	1,017	1,088	-	-	-
A fellow subsidiary	28	-	240	-	-	-
Related companies	44	3,934	1,994	-	-	-
Less: Provision for impairment of receivables	(2,672)	(4,218)	(4,467)	-	-	-
	111,542	221,282	233,258	-	-	-
Prepayments, deposits and other receivables	42,514	37,183	50,286	4,664	687	921
	<u>154,056</u>	<u>258,465</u>	<u>283,544</u>	<u>4,664</u>	<u>687</u>	<u>921</u>

- (a) The credit terms granted to sales agents and other trade customers are generally ranging from 15 to 90 days.
- (b) The amounts due from immediate holding company, an associate, a fellow subsidiary and related companies are unsecured, interest free and have credit periods ranging from 15 to 90 days.
- (c) The age analysis of the net trade receivables with third parties, immediate holding company, an associate, a fellow subsidiary and related companies is as follows:

	CNAC Group		
	At 31 December		
	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000
Within 31 days	103,643	180,828	194,210
31 – 60 days	7,198	19,433	20,414
61 – 90 days	112	8,661	8,882
Over 90 days	589	12,360	9,752
	<u>111,542</u>	<u>221,282</u>	<u>233,258</u>

- (d) There is no concentration of credit risk with respect to trade receivables, as the CNAC Group has a large number of customers, internationally dispersed.
- (e) Approximately 62% and 19% of the gross trade receivables balance of the CNAC Group at 31 December 2003 (2004: 41% and 39%; 2005: 37% and 44%) are denominated in Taiwanese Dollars and Renminbi ("RMB") respectively. The remaining balances are mainly denominated in MOP and US\$.

27. Cash and cash equivalents and pledged bank deposits

	CNAC Group			CNAC		
	At 31 December			At 31 December		
	2003	2004	2005	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000
Cash at bank and in hand	100,952	260,314	365,532	–	45,710	25,884
Short-term bank deposits	961,614	553,934	723,244	813,612	336,259	483,256
Total	1,062,566	814,248	1,088,776	813,612	381,969	509,140
Less: Pledged bank deposits against						
– Financial derivative facilities	(4,571)	(4,897)	(4,724)	–	–	–
– Bank guarantees on aircraft leasing	(20,679)	(56,323)	(84,006)	–	–	–
– Others	(387)	(6,235)	(213)	–	–	–
Total pledged bank deposits	(25,637)	(67,455)	(88,943)	–	–	–
Cash and cash equivalents	1,036,929	746,793	999,833	813,612	381,969	509,140

Cash and cash equivalents and pledged bank deposits include HK\$23,988,000, HK\$81,855,000 and HK\$250,442,000 which are denominated in RMB and are held by the CNAC Group and its jointly controlled entities with bank accounts operating in China mainland where exchange controls apply for the years ended 31 December 2003, 2004 and 2005 respectively.

The effective interest rate on short-term bank deposits was 0.184%, 1.016% and 3.587% for the years ended 31 December 2003, 2004 and 2005 respectively. These deposits have an average maturity of approximately 64 days, 45 days and 54 days respectively.

The total cash and bank balances are denominated in the following currencies:

	CNAC Group			CNAC		
	At 31 December			At 31 December		
	2003	2004	2005	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000
HK\$	757,069	287,410	376,551	751,528	276,091	368,787
RMB	25,177	203,467	322,817	–	–	–
US\$	120,268	230,161	302,154	62,084	105,878	140,353
Others	160,052	93,210	87,254	–	–	–
	1,062,566	814,248	1,088,776	813,612	381,969	509,140

28. Share capital

	Ordinary shares of HK\$0.10 each	
	Number of Shares	HK\$'000
Authorised:		
At 1 January 2003, 2004, 2005 and 31 December 2005	<u>4,000,000,000</u>	<u>400,000</u>
Issued and fully paid:		
At 1 January 2003	3,319,308,000	331,931
Repurchase of own Shares (<i>note b</i>)	<u>(6,628,000)</u>	<u>(663)</u>
At 1 January 2004, 2005 and 31 December 2005	<u>3,312,680,000</u>	<u>331,268</u>

(a) Share options

At an Annual General Meeting of CNAC held on 29 May 2002, a share option scheme ("Share Option Scheme") was approved by the shareholders of CNAC. Under the terms of the Share Option Scheme, the Directors may, at their discretion, grant to any Director, employee, supplier, customer or other relevant business partners of the CNAC Group, Options to subscribe for the Shares at the subscription price of the highest of (i) the closing price of the Shares as stated in the Stock Exchange's daily quotations sheets on the date of grant; (ii) the average closing price of the Shares 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 Shares. A nominal consideration at HK\$1 was paid by the grantees for the acceptance of the grant of Options.

The maximum number of Shares may be issued upon exercise of all outstanding Options granted and yet to be exercised under the Share Option Scheme and any other share option scheme of the CNAC Group must not exceed 30% of the number of issued shares of CNAC from time to time.

The total number of Shares to be granted under the Share Option Scheme and any other share option scheme of the CNAC Group shall not exceed 331,268,000, representing 10% of the number of issued Shares at the date of adoption of the Share Option Scheme.

An Option may be exercised in accordance with the terms of the Share Option Scheme at any time during a period, in relation to the relevant Option, to be notified by the Directors to the grantee, such period not exceeding six years commencing on the date falling three months after the date of grant and expiring on the last day of the said period.

The Share Option Scheme will remain in force for a period of ten years commencing on the date on which it was adopted.

Movements in the number of Options outstanding during the Relevant Periods and their related weighted average exercise price are as follows:

	2003		2004		2005	
	Weighted average price HK\$	Number of Options	Weighted average price HK\$	Number of Options	Weighted average price HK\$	Number of Options
At 1 January	0.992	147,059,800	1.064	136,729,800	1.140	104,378,000
Granted (<i>note (i)</i>)	1.140	104,378,000	-	-	-	-
Lapsed	1.040	<u>(114,708,000)</u>	0.820	<u>(32,351,800)</u>	-	-
At 31 December (<i>note (ii)</i>)	1.064	<u>136,729,800</u>	1.140	<u>104,378,000</u>	1.140	<u>104,378,000</u>

Notes:

- (i) Options were granted on 25 July 2003 at the exercise price of HK\$1.140 per Share and will expire on 25 October 2009. Consideration received was HK\$4 in respect of the Options granted during the year ended 31 December 2003.
- (ii) No Options were exercised during the Relevant Periods.
- (iii) Options outstanding at end of the Relevant Periods have the following terms:

Expiry date	Exercise Price HK\$	Number of Options			Vested percentages		
		2003	2004	2005	2003	2004	2005
Directors							
24 March 2004	0.820	32,351,800	-	-	100%	-	-
25 October 2009	1.140	<u>104,378,000</u>	<u>104,378,000</u>	<u>104,378,000</u>	100%	100%	100%
		<u>136,729,800</u>	<u>104,378,000</u>	<u>104,378,000</u>			

- (b) *Repurchase of own shares*

In April 2003, CNAC repurchased a total of 6,628,000 Shares at an aggregated consideration of HK\$5,325,000. The highest and lowest prices per Share paid for the repurchase were HK\$0.83 and HK\$0.77 respectively. The above Shares repurchased were then cancelled.

29. Reserves

CNAC Group

	Share premium HK\$'000	Capital redemption reserve HK\$'000	Legal reserve HK\$'000	Investments revaluation reserve HK\$'000	Exchange reserve HK\$'000	Cashflow hedge reserve HK\$'000	Retained earnings HK\$'000	Total HK\$'000
Balance at 1 January 2003	1,434,558	-	3,666	4,180	-	-	921,785	2,364,189
Share of currency translation differences of associates	-	-	-	-	-	-	59	59
Share of deficit on revaluation of investments in securities of an associate	-	-	-	(1,716)	-	-	-	(1,716)
Net (expense)/income recognised directly in equity	-	-	-	(1,716)	-	-	59	(1,657)
Loss for the year	-	-	-	-	-	-	(17,295)	(17,295)
Total recognised loss for 2003	-	-	-	(1,716)	-	-	(17,236)	(18,952)
Repurchase of own shares (note 28(b))	-	663	-	-	-	-	(5,325)	(4,662)
Dividends	-	-	-	-	-	-	(36,439)	(36,439)
Balance at 31 December 2003	<u>1,434,558</u>	<u>663</u>	<u>3,666</u>	<u>2,464</u>	<u>-</u>	<u>-</u>	<u>862,785</u>	<u>2,304,136</u>
Representing:								
Proposed final dividend								19,876
Others								2,284,260
								<u>2,304,136</u>
Balance at 1 January 2004	1,434,558	663	3,666	2,464	-	-	862,785	2,304,136
Share of currency translation differences of associates	-	-	-	-	-	-	51	51
Share of deficit on revaluation of investments in securities of an associate	-	-	-	(2,464)	-	-	-	(2,464)
Net (expense)/income recognised directly in equity	-	-	-	(2,464)	-	-	51	(2,413)
Profit for the year	-	-	-	-	-	-	360,969	360,969
Total recognised (loss)/income for 2004	-	-	-	(2,464)	-	-	361,020	358,556
Transfer (note a)	-	-	43	-	-	-	(43)	-
Dividends	-	-	-	-	-	-	(39,752)	(39,752)
Balance at 31 December 2004	<u>1,434,558</u>	<u>663</u>	<u>3,709</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>1,184,010</u>	<u>2,622,940</u>
Representing:								
Proposed final dividend								33,127
Others								2,589,813
								<u>2,622,940</u>

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**FINANCIAL INFORMATION
RELATING TO THE CNAC GROUP**

	Share premium HK\$'000	Capital redemption reserve HK\$'000	Legal reserve HK\$'000	Exchange reserve HK\$'000	Cashflow hedge reserve HK\$'000	Retained earnings HK\$'000	Total HK\$'000
Balance at 1 January 2005	1,434,558	663	3,709	-	-	1,184,010	2,622,940
Share of opening adjustments on adoption of HKAS 39 by associates (<i>note b</i>)	-	-	-	-	(20,056)	1,033	(19,023)
Balance at 1 January 2005, as restated	1,434,558	663	3,709	-	(20,056)	1,185,043	2,603,917
Share of currency translation differences of associates	-	-	-	-	-	84	84
Share of fair value gains of derivative financial instruments of associates	-	-	-	-	25,319	-	25,319
Currency translation differences	-	-	-	(123)	-	-	(123)
Net (expense)/income recognised directly in equity	-	-	-	(123)	25,319	84	25,280
Profit for the year	-	-	-	-	-	225,000	225,000
Total recognised (loss)/income for 2005	-	-	-	(123)	25,319	225,084	250,280
Transfer (<i>note a</i>)	-	-	6,599	-	-	(6,599)	-
Dividends	-	-	-	-	-	(59,628)	(59,628)
Balance at 31 December 2005	<u>1,434,558</u>	<u>663</u>	<u>10,308</u>	<u>(123)</u>	<u>5,263</u>	<u>1,343,900</u>	<u>2,794,569</u>
Representing:							
Proposed final dividend							33,127
Others							<u>2,761,442</u>
							<u>2,794,569</u>

(a) A subsidiary in Macau and jointly controlled entities in China mainland have transferred 10% of their profits to non-distributable legal reserve in accordance with local rules and regulations respectively.

(b) The adoption of HKAS 39 has resulted in the recognition of financial instruments at fair value and the change in the recognition and measurement of hedging activities.

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FINANCIAL INFORMATION
RELATING TO THE CNAC GROUP

CNAC

	Share premium <i>HK\$'000</i>	Capital redemption reserve <i>HK\$'000</i>	Retained earnings <i>HK\$'000</i>	Total <i>HK\$'000</i>
At 1 January 2003	1,434,558	–	660,641	2,095,199
Profit for the year	–	–	36,173	36,173
Repurchase of own Shares	–	663	(5,325)	(4,662)
Dividends	–	–	(36,439)	(36,439)
	<u>1,434,558</u>	<u>663</u>	<u>655,050</u>	<u>2,090,271</u>
At 31 December 2003	<u>1,434,558</u>	<u>663</u>	<u>655,050</u>	<u>2,090,271</u>
Representing:				
Proposed final dividend				19,876
Others				<u>2,070,395</u>
				<u>2,090,271</u>
At 1 January 2004	1,434,558	663	655,050	2,090,271
Profit for the year	–	–	64,735	64,735
Dividends	–	–	(39,752)	(39,752)
	<u>1,434,558</u>	<u>663</u>	<u>680,033</u>	<u>2,115,254</u>
At 31 December 2004	<u>1,434,558</u>	<u>663</u>	<u>680,033</u>	<u>2,115,254</u>
Representing:				
Proposed final dividend				33,127
Others				<u>2,082,127</u>
				<u>2,115,254</u>
At 1 January 2005	1,434,558	663	680,033	2,115,254
Profit for the year	–	–	203,468	203,468
Dividends	–	–	(59,628)	(59,628)
	<u>1,434,558</u>	<u>663</u>	<u>823,873</u>	<u>2,259,094</u>
At 31 December 2005	<u>1,434,558</u>	<u>663</u>	<u>823,873</u>	<u>2,259,094</u>
Representing:				
Proposed final dividend				33,127
Others				<u>2,225,967</u>
				<u>2,259,094</u>

30. Provision for overhaul and major checks

	CNAC Group		
	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000
At 1 January	53,695	64,869	91,939
Charged during the year (note 10)	95,658	84,772	138,427
Utilised during the year	(84,484)	(57,702)	(75,462)
At 31 December	<u>64,869</u>	<u>91,939</u>	<u>154,904</u>

31. Provision for housing allowances

	CNAC Group		
	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000
At 1 January	-	-	-
Charged during the year (note 9)	-	-	45,311
Utilised during the year	-	-	(6,156)
At 31 December	-	-	39,155
Current portion included in other payables and accruals	-	-	(5,029)
	<u>-</u>	<u>-</u>	<u>34,126</u>

32. Trade and other payables

	CNAC Group			CNAC		
	At 31 December			At 31 December		
	2003	2004	2005	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000
Trade payables (note a)	117,016	133,836	229,602	-	-	-
Due to (notes a and b):						
Associates	13,869	14,698	14,075	-	-	-
Fellow subsidiaries	11,945	15,720	17,390	50	-	31
Immediate holding company	-	15,892	-	-	-	-
Related companies	63	4,039	11,878	-	-	-
Other payables and accruals	<u>166,489</u>	<u>232,387</u>	<u>241,678</u>	<u>4,160</u>	<u>4,343</u>	<u>4,337</u>
	<u>309,382</u>	<u>416,572</u>	<u>514,623</u>	<u>4,210</u>	<u>4,343</u>	<u>4,368</u>

- (a) The age analysis of trade payable with third parties, an associate, fellow subsidiaries and related companies is as follows:

	CNAC Group			CNAC		
	At 31 December			At 31 December		
	2003	2004	2005	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000
Within 31 days	68,208	103,314	191,664	-	-	-
31 – 60 days	36,030	39,569	47,243	-	-	-
61 – 90 days	11,392	12,393	17,038	-	-	-
Over 90 days	27,213	9,040	9,674	-	-	-
	<u>142,843</u>	<u>164,316</u>	<u>265,619</u>	<u>-</u>	<u>-</u>	<u>-</u>

- (b) The amounts due to associates, fellow subsidiaries, immediate holding company and related companies are unsecured and interest free. Except for the amount due to immediate holding company at 31 December 2004 which had no fixed terms of repayment, other balances have the credit terms generally ranging from 30 to 90 days.
- (c) Approximately 65% and 12% of the trade payables balance of the CNAC Group at 31 December 2003 (2004: 49% and 29%; 2005: 67% and 19%) are denominated in US\$ and RMB respectively. The remaining balances are mainly denominated in MOP and Taiwanese Dollars.

33. Short-term bank loans

	CNAC Group		
	At 31 December		
	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000
Short-term bank loans, unsecured	<u>-</u>	<u>69,217</u>	<u>25,371</u>

The average effective interest rate at the balance sheet date was 4.59% and 5.02% for the years ended 31 December 2004 and 2005 respectively.

The carrying amounts of short-term bank loans approximate their fair values and are denominated in RMB at 31 December 2004 and 2005.

34. Deferred income tax assets

Deferred income taxes are calculated in full on temporary differences under the liability method using the statutory profits tax rate prevailing in which the CNAC Group's principal operating subsidiary operates of 15.75%, 15.75% and 12% for the years ended 31 December 2003, 2004 and 2005 respectively.

The movement in deferred income tax assets during the Relevant Periods is as follows:

	Accelerated depreciation allowances <i>HK\$'000</i>	Provisions <i>HK\$'000</i>	Tax losses <i>HK\$'000</i>	Total <i>HK\$'000</i>
Year ended 31 December 2003				
At 1 January 2003	–	–	–	–
Credited to income statement (note 12)	–	–	30,333	30,333
At 31 December 2003	<u>–</u>	<u>–</u>	<u>30,333</u>	<u>30,333</u>
Year ended 31 December 2004				
At 1 January 2004	–	–	30,333	30,333
Acquisition of jointly controlled entities (note 35(b))	2,438	47	–	2,485
(Charged)/credited to income statement (note 12)	(24)	22	(11,039)	(11,041)
At 31 December 2004	<u>2,414</u>	<u>69</u>	<u>19,294</u>	<u>21,777</u>
Year ended 31 December 2005				
At 1 January 2005	2,414	69	19,294	21,777
Decrease in opening deferred taxation resulting from a reduction in tax rate	–	–	(4,594)	(4,594)
Credited/(charged) to income statement	291	10,572	(4,619)	6,244
At 31 December 2005	<u>2,705</u>	<u>10,641</u>	<u>10,081</u>	<u>23,427</u>
		At 31 December		
		2003	2004	2005
		<i>HK\$'000</i>	<i>HK\$'000</i>	<i>HK\$'000</i>
Deferred tax assets to be recovered after more than 12 months		<u>19,494</u>	<u>21,777</u>	<u>23,427</u>

Deferred income tax assets are recognised for tax losses carry forwards to the extent that realisation of the related tax benefit through the future taxable profits is probable. The CNAC Group has unrecognised tax losses of HK\$54,155,000, HK\$78,703,000 and HK\$141,638,000 for the years ended 31 December 2003, 2004 and 2005 respectively to carry forward against future taxable income, in which losses of HK\$54,155,000, HK\$70,923,000 and HK\$90,185,000 have no expiry date and losses of HK\$7,780,000 and HK\$51,453,000 will be expired in 2007 and 2008 respectively.

CNAC has not recognised tax losses of HK\$54,155,000, HK\$70,923,000 and HK\$90,185,000 that can be carried forward against future taxable income for the years ended 31 December 2003, 2004 and 2005 respectively. These tax losses have no expiry date.

35. Notes to the consolidated cash flow statement

(a) Cash (used in)/generated from operations

	Year ended 31 December		
	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000
Operating (loss)/profit	(223,583)	16,733	(52,317)
Adjustments for:			
Depreciation	68,519	66,006	78,131
Amortisation of intangible assets	18,978	20,144	9
Amortisation of land use right	–	10	81
Gain on disposal of an available-for-sale investment	–	–	(1,207)
Fair value gains on derivative financial instruments	–	–	(10,593)
Loss/(gain) on disposal of property, plant and equipment	458	334	(41)
Provision for housing allowances	–	–	39,155
Provision for impairment of loan to an associate	–	–	446
Write-off of an investment security	–	249	–
Interest income	(9,172)	(4,891)	(20,159)
	<u>(144,800)</u>	<u>98,585</u>	<u>33,505</u>
Changes in working capital:			
Inventories	340	1,452	772
Lease and equipment deposits	5,214	14,279	8,653
Trade and other receivables	30,997	(30,321)	(26,443)
Trade and other payables	(4,780)	39,988	92,899
Sales in advance of carriage	1,226	10,592	14,333
Provision for overhaul and major checks	11,174	27,070	62,965
	<u>111,174</u>	<u>102,158</u>	<u>152,124</u>
Cash (used in)/generated from operations	<u>(100,629)</u>	<u>161,645</u>	<u>186,684</u>

(b) Purchase of jointly controlled entities

In April 2004, the CNAC Group entered into share transfer contracts with Air China International Corporation ("Air China International") pursuant to which the CNAC Group agreed to acquire 60% of equity interests in BACL and SWACL from Air China International at the considerations of RMB294 million and RMB67 million respectively (the "BACL and SWACL Acquisitions"). The BACL and SWACL Acquisitions were completed on 16 November 2004.

Details of share of net assets of jointly controlled entities acquired and goodwill are as follows:

	2004 <i>HK\$'000</i>
Net assets acquired	
Property, plant and equipment (<i>note 16</i>)	125,061
Land use right	2,365
Deferred income tax assets (<i>note 34</i>)	2,485
Investment securities	18,562
Inventories	4,673
Trade and other receivables	74,088
Cash and cash equivalents	18,520
Pledged bank deposits	6,120
Trade and other payables	(51,386)
Amount due to immediate holding company	(15,892)
Short-term bank loans, unsecured	(80,506)
Current tax liabilities	(2,015)
	<hr/>
	102,075
Goodwill (<i>note 18</i>)	243,198
	<hr/>
	345,273
	<hr/> <hr/>
Satisfied by	
Cash	345,273
	<hr/> <hr/>

No intangible asset was individually identified and separately recognised in the BACL and SWACL Acquisitions as the Directors of CNAC consider that no item can meet the identifiability criterion in the definition of an intangible asset.

Analysis of the net cash outflow in respect of the purchase of jointly controlled entities:

	2004 <i>HK\$'000</i>
Cash consideration	345,273
Cash and cash equivalents acquired	(18,520)
	<hr/>
Net cash outflow in respect of the purchase of jointly controlled entities	326,753
	<hr/> <hr/>

36. Commitments

- (a) On 16 February 2001, the CNAC Group entered into an agreement with third parties (the "Consortium Partners") in respect of the joint development and operation of Tradeport Logistics Centre at the South Commercial District of the Hong Kong International Airport (the "Project"). The CNAC Group, through its interest in Tradeport Hong Kong, an associate of the CNAC Group, has 25% effective interest in the Project. Initially, the maximum liability limit imposed by the Airport Authority Hong Kong was HK\$780,000,000. On 17 March 2004, the Airport Authority Hong Kong agreed to reduce the maximum liability limit to HK\$312,000,000. The CNAC Group's attributable share of capital commitments in respect of the Project was approximately HK\$130,650,000 at 31 December 2003 and approximately HK\$78,000,000 at 31 December 2004 and 2005.

In the event of default of any of the Consortium Partners, the CNAC Group will be required to provide additional funds for the Project. The CNAC Group and the Consortium Partners have jointly given a guarantee to the Airport Authority Hong Kong in respect of their obligations to provide sufficient funding for the Project. Should the CNAC Group be required to perform its obligations under the guarantee in the event of default of all of the Consortium Partners, the maximum amount of the additional liabilities assumed, in addition to the CNAC Group's estimated share of capital commitments as disclosed above, would be approximately HK\$649,350,000 at 31 December 2003 and HK\$234,000,000 at 31 December 2004 and 2005.

(b) Commitments under operating leases

The CNAC Group had future aggregate minimum lease payments under non-cancellable operating leases in respect of aircraft and related equipment as follows:

	CNAC Group		
	Year ended 31 December		
	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000
Not later than one year	290,071	357,491	644,852
Later than one year and not later than five years	831,081	1,011,211	873,291
More than five years	609,249	407,760	265,202
	<u>1,730,401</u>	<u>1,776,462</u>	<u>1,783,345</u>

The above operating lease commitments included commitment for fixed rent only. Rentals payable in some cases include an additional rent, calculated according to exact flying hours, in excess of a fixed rent.

(c) Future minimum rental payments receivables

The CNAC Group had future minimum lease receipts under non-cancellable operating lease in respect of aircraft as follows:

	CNAC Group		
	Year ended 31 December		
	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000
Not later than one year	<u>-</u>	<u>10,241</u>	<u>14,617</u>

(d) Capital commitments

The CNAC Group's attributable share of capital expenditure contracted for by the CNAC Group's jointly controlled entities but not yet incurred is as follows:

	CNAC Group		
	Year ended 31 December		
	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000
Property, plant and equipment	<u>-</u>	<u>-</u>	<u>3,966</u>

37. Contingent liabilities

	CNAC Group and CNAC		
	At 31 December		
	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000
Guarantee for banking facilities granted by bank to:			
– An associate	15,000	15,000	20,000
– A jointly controlled entity (<i>note</i>)	–	–	87,475
	<u>15,000</u>	<u>15,000</u>	<u>107,475</u>

Note:

At 31 December 2005, the CNAC Group had given to a bank for loan facilities granted to a jointly controlled entity of RMB115,000,000 (equivalent to approximately HK\$110,545,000). Loans of RMB40,000,000 (equivalent to approximately HK\$38,450,000) were drawdown by the jointly controlled entity at 31 December 2005. The CNAC Group's proportionate share of bank loans of HK\$23,070,000 had been included in the consolidated balance sheet at 31 December 2005.

38. Related party transactions

The CNAC Group is part of a larger group of companies under Air China and has extensive transactions and relationships with members of the Air China Group. Because of these relationships, it is possible that the terms of transactions between the CNAC Group and members of Air China Group are not the same as those that would result from transactions with or among other related parties or wholly unrelated parties.

Air China is controlled by CNAH, a state-owned enterprise which is wholly owned by the PRC government. As CNAC is indirectly controlled by the PRC government, state-owned enterprises and their subsidiaries, in addition to the group companies of Air China, directly or indirectly owned by the PRC government are also related parties of the CNAC Group.

A portion of the CNAC Group's business activities are conducted with other state-owned enterprises. For the purpose of related party transactions disclosure, the CNAC Group has identified, to the extent practicable, those corporate customers and suppliers which are state-owned enterprises based on their immediate ownership structure. It should be noted, however, that a substantial portion of the CNAC Group's business activities are conducted in the PRC and the influence of the PRC government in the Chinese economy is pervasive. In this regard, the PRC government indirectly holds interests in many companies. In addition, a portion of the CNAC Group's services provided are of a retail nature to end users, which include transactions with the employees of state-owned enterprises on corporate business, their key management personnel and close family members. Due to the vast volume and the pervasiveness of these transactions, the CNAC Group is unable to determine the aggregate amount of these transactions for disclosure. Therefore, the revenue from provision of services disclosed below does not include retail transactions with these related parties. However, the CNAC Group believes that meaningful information in respect of related party transactions has been adequately disclosed.

The following is a summary of significant transactions carried out with related parties in the ordinary course of business for the Relevant Periods:

(a) Revenue, other gains and expenses

	Year ended 31 December		
	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000
Revenue and other gains:			
Value of tickets sold to (<i>note i</i>):			
– Immediate holding company	–	1,545	3,365
– An associate	550	2,032	1,391
– Fellow subsidiaries	4,201	3,395	2,944
– Related companies	15,468	7,755	8,568
Lease of an aircraft to immediate holding company (<i>note ii</i>)	–	9,855	41,532
Sales of goods (<i>note iii</i>):			
– Immediate holding company	–	17,156	136,663
– An associate	–	2,428	10,979
– Related companies	–	142	3,417
– Other state-owned enterprises (<i>note xi</i>)	–	1,540	19,468
Interest income from other state-owned banks (<i>note xi</i>)	7,357	2,704	14,999

	Year ended 31 December		
	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000
Operating expenses:			
Management fee paid to fellow subsidiaries (<i>notes iv and v</i>)	9,600	9,600	9,600
Landing, loading, parking and other airport charges paid to:			
– A fellow subsidiary (<i>note vi</i>)	51,927	69,337	86,343
– Other state-owned enterprises (<i>note xi</i>)	25,220	34,811	40,976
Ground handling costs paid to an associate (<i>note vii</i>)	93,858	119,866	129,777
Technical and ground handling costs paid to an associate (<i>note viii</i>)	3,201	4,475	2,634
Inflight meal services expenses paid to a related company (<i>note ix</i>)	40,637	41,199	51,491
Lease rental paid to fellow subsidiaries (<i>note x</i>)	–	688	1,652
Fuel costs paid to an other state-owned enterprise (<i>note xi</i>)	13,548	10,236	85,409
Finance cost paid to other state-owned banks (<i>note xi</i>)	–	375	2,960
Project management fee paid to immediate holding company (<i>note xii</i>)	–	–	1,344

(i) Air tickets were sold to the related ticket sales agents in accordance with the pricing policy of the CNAC Group.

(ii) The CNAC Group entered into a lease agreement with Air China pursuant to which the CNAC Group leases aircraft to Air China at a monthly fee of US\$359,000 (equivalent to approximately HK\$2,796,000) with monthly maintenance hour charge of US\$470 (equivalent to approximately HK\$4,000) per block hour.

- (iii) The inflight meal services rendered were charged at terms pursuant to agreements entered into by BACL and SWACL with relevant related parties.
- (iv) Pursuant to the management services agreement dated 27 August 2003 entered into between CNAC and China National Aviation Corporation (Group) Limited (“CNACG”), a fellow subsidiary, CNACG provided secretarial, personnel, accounting and general office administrative services to the CNAC Group for a period of two years from 1 July 2003 to 30 June 2005 at a monthly fee of HK\$500,000.
- On 28 July 2005, CNAC and CNACG renewed the management services agreement with the same terms under the management services agreement dated 27 August 2003 for a period of three years from 1 July 2005 to 30 June 2008 at a monthly fee of HK\$500,000.
- (v) Pursuant to the management services agreement dated 25 March 2002 entered into between the CNAC Group and CNAC (Macau) Aviation Limited (“CNACAL”), a fellow subsidiary, CNACAL agreed to provide general management services including but not limited to secretarial, personnel, accounting and general office administrative services to CNAC Macau for a period of three years from 25 March 2002 to 24 March 2005 at a monthly fee of HK\$300,000.
- On 4 November 2005, CNAC Macau and CNACAL renewed the management services agreement with the same terms under the management services agreement dated 25 March 2002 for a period of three years from 25 March 2005 to 24 March 2008 at a monthly fee of HK\$300,000.
- (vi) The airport related charges paid to ADA-Administrative Airport Limited (“ADA”) were at terms pursuant to the tariff published by the Macau Government in the government gazette.
- (vii) The ground handling services rendered were charged at terms pursuant to agreements entered into by the CNAC Group with Menzies Macau.
- (viii) The technical and ground handling services rendered were charged at terms pursuant to agreements entered into by the CNAC Group with Dragonair.
- (ix) The inflight meal services rendered were charged at terms pursuant to agreements entered into by the CNAC Group with Macau Catering Services Company Limited, a 34.5% owned associate held by a minority shareholder of Air Macau.
- (x) The CNAC 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 CNAC Group at a monthly rental of MOP141,800 (equivalent to approximately HK\$138,000).
- (xi) The above transactions with other state-owned enterprises and banks were entered into in accordance with the terms as set out in the agreements governing the transactions or as mutually agreed between the parties.
- (xii) On 4 November 2005, BACL entered into a project management services agreement with Air China Beijing Construction Base Command Centre (“Air China Command Centre”), a division of CNAH, for services relating to the phase 3 construction work in respect to the expansion of the ancillary facilities in the Beijing Capital International Airport (“Capital Airport”) during its commencement, construction and post-completion stages.

Pursuant to the project management services agreement, total management fee is equivalent to 2.5% of the approved budget of the construction work for the project. The estimated construction cost as set out in the "Feasibility Study Report regarding the construction work of ancillary facilities of Air China in Capital Airport" of RMB310,850,000 (equivalent to approximately HK\$300,000,000) is used as the base figure for determining the management fee as the construction budget is yet to approve. The amount represented 30% project management fee paid to Air China Command Centre upon signing of the project management services agreement.

- (xiii) In April 2004, the CNAC Group entered into share transfer contracts with Air China International pursuant to which the CNAC Group agreed to acquire 60% of equity interests in BACL and SWACL from Air China International at considerations of RMB294 million and RMB67 million respectively. The transactions were completed in November 2004 (note 35(b)).
- (xiv) In August 2004, the CNAC Group entered into sale and purchase agreements with CNACG pursuant to which the CNAC Group agreed to acquire 16% of equity interests in LLSHK from CNACG at a consideration of HK\$89 million. The transaction was completed in December 2004.
- (b) On 18 October 1997, CNAC entered into a license agreement with China National Aviation Corporation ("CNA") pursuant to which CNA has agreed to grant a license to CNAC, free of royalty, for the use of certain trademarks in Hong Kong, the Taiwan region and Macau so long as CNAC is a subsidiary of CNACG ("Old License Agreement").

On 25 August 2004, CNACG entered into two license agreements with CNAC pursuant to which CNACG has agreed to grant licenses to CNAC, free of royalty, for the rights to use those trademarks in Hong Kong and Macau, respectively, so long as CNAC is a direct or indirect subsidiary of CNAH ("New License Agreements").

No royalty charge was levied under the Old License Agreement and the New License Agreements in respect of the use of these trademarks during the period.

- (c) Key management compensation

	Year ended 31 December		
	2003	2004	2005
	HK\$'000	HK\$'000	HK\$'000
Directors' fees	2,342	3,355	3,480
Salaries and other short-term employee benefits	6,345	7,066	7,457
	<u>8,687</u>	<u>10,421</u>	<u>10,937</u>

- (d) Year-end balances arising from sales/purchases of goods/services with related parties comprised:

	At 31 December		
	2003 HK\$'000	2004 HK\$'000	2005 HK\$'000
Receivables from related parties (<i>note</i>)			
Immediate holding company	–	36,245	29,412
An associate	30	1,017	1,088
A fellow subsidiary	28	–	240
Related companies	44	3,934	1,994
Other state-owned enterprises	–	9,910	6,145
	<u>102</u>	<u>51,106</u>	<u>38,879</u>
Bank deposits			
Other state-owned banks	<u>843,610</u>	<u>597,703</u>	<u>823,737</u>
Payables to related parties (<i>note</i>)			
An associate	13,869	14,698	14,075
Fellow subsidiary	11,945	15,720	17,359
Related companies	63	62	4,583
Other state-owned enterprises	11,216	23,410	26,887
	<u>37,093</u>	<u>53,890</u>	<u>62,904</u>
Short-term bank loans			
Other state-owned banks	<u>–</u>	<u>69,217</u>	<u>25,371</u>

Note:

Repayment terms of these balances with the above related parties have been disclosed in notes 26 and 32.

(III) EVENTS AFTER THE BALANCE SHEET DATE

- (a) On 24 January 2006, the CNAC Group entered into agreements (“Macau Asia Express Agreement”) with Shun Tak Air Transport Limited and its subsidiaries respectively to establish Macau Asia Express Limited in order to engage in the business activities of operating low cost model air transport services based in Macau. The CNAC Group will hold 43.7% effective equity interest (including indirect interest) in Macau Asia Express Limited. The aggregate initial investment in Macau Asia Express Limited is limited to approximately HK\$234,000,000 and the CNAC Group’s attributable share of the investment cost will be funded by the CNAC Group’s internal resources. The completion of the establishment is subject to certain conditions to be fulfilled.

Macau Asia Express Limited will be accounted for as a jointly controlled entity in accordance with HKAS 31 “Investments in joint ventures”.

- (b) On 8 June 2006, CNAC entered into a conditional agreement with Cathay pursuant to which CNAC agreed to dispose of the CNAC Group's entire interests in Dragonair, an associate of the CNAC Group, to Cathay at a consideration to be satisfied by a combination of the issue of 288,596,335 new shares by Cathay at an issue price of HK\$13.50 per share and cash consideration of HK\$432,894,498. The completion of this transaction is subject to, amongst others, the approval of the shareholders of CNAC.

Upon the completion, CNAC will hold 7.34% equity interests in Cathay and such investment will be classified as available-for-sale investment in the balance sheet and carried at fair value.

Details of the selected financial information of Dragonair are set out in note 21(a) above.

(B) UNAUDITED CONDENSED CONSOLIDATED FINANCIAL INFORMATION OF THE CNAC GROUP FOR THE SIX MONTHS ENDED 30 JUNE 2006

Subject to the adoption of the definitions in this document, set out below is the unaudited condensed income statement, cash flow statement and statement of recognised income and expense for each of the six months ended 30 June, 2005 and 30 June 2006 and the unaudited condensed balance sheets as at 31 December 2005 and 30 June 2006, together with the relevant notes, as extracted from the unaudited interim financial report of CNAC for the period ended 30 June 2006.

UNAUDITED CONDENSED CONSOLIDATED INCOME STATEMENT

	<i>Note</i>	Six months ended 30th June	
		2006 HK\$'000	2005 HK\$'000
Turnover	3	1,431,170	1,199,150
Other revenues		3,785	27,235
Total revenues		<u>1,434,955</u>	<u>1,226,385</u>
Other gains		<u>52,262</u>	<u>23,329</u>
Staff costs		(193,236)	(155,140)
Passenger catering and service costs		(123,999)	(114,971)
Fuel costs		(408,193)	(277,603)
Route operating costs		(280,785)	(247,039)
Aircraft maintenance costs		(110,640)	(109,725)
Aircraft leases and equipment costs		(235,493)	(206,701)
Depreciation and amortisation costs		(38,698)	(37,530)
Sales and promotion costs		(37,630)	(38,336)
Other operating costs		(59,465)	(43,899)
Total operating expenses		<u>(1,488,139)</u>	<u>(1,230,944)</u>
Operating (loss)/profit	4	(922)	18,770
Finance costs	5	(504)	(1,802)
Share of profits less losses of associates		50,080	120,498
Profit before income tax		48,654	137,466
Income tax	6	(9,384)	(5,812)
Profit for the period		<u>39,270</u>	<u>131,654</u>
Attributable to:			
Equity holders of CNAC		43,484	122,910
Minority interests		(4,214)	8,744
		<u>39,270</u>	<u>131,654</u>
Interim dividend	7	<u>–</u>	<u>26,501</u>
		<i>HK cents</i>	<i>HK cents</i>
Earnings per Share	8		
– Basic		<u>1.31</u>	<u>3.71</u>
– Diluted		<u>1.29</u>	<u>3.67</u>

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEET

		Unaudited 30th June, 2006 HK\$'000	Restated 31st December, 2005 HK\$'000
	<i>Note</i>		
ASSETS			
Non-current assets			
Property, plant and equipment	9	450,997	471,692
Land use right	9	2,233	2,274
Intangible assets	9	529,240	529,240
Interests in associates	10	313,655	1,652,454
Loans to associates		64,219	47,097
Lease and equipment deposits		62,723	60,109
Deferred income tax assets		20,709	23,427
Pledged bank deposits	14	101,220	88,943
		<u>1,544,996</u>	<u>2,875,236</u>
Current assets			
Inventories		54,205	53,273
Trade and other receivables	12	306,939	283,544
Loan to an associate		–	18,060
Derivative financial instruments		39,215	11,957
Assets classified as held for sale	13	1,369,264	–
Cash and cash equivalents	14	1,030,930	999,833
		<u>2,800,553</u>	<u>1,366,667</u>
Total assets		<u><u>4,345,549</u></u>	<u><u>4,241,903</u></u>
EQUITY			
Capital and reserves attributable to CNAC's equity holders			
Share capital	15	331,268	331,268
Reserves		2,852,355	2,786,302
Proposed dividend		–	33,127
		<u>3,183,623</u>	<u>3,150,697</u>
Minority interests		<u>223,138</u>	<u>227,352</u>
Total equity		<u><u>3,406,761</u></u>	<u><u>3,378,049</u></u>

APPENDIX I

FINANCIAL INFORMATION
RELATING TO THE CNAC GROUP

		Unaudited 30th June, 2006 HK\$'000	Restated 31st December, 2005 HK\$'000
	<i>Note</i>		
LIABILITIES			
Non-current liabilities			
Provision for overhaul and major checks		188,390	154,904
Provision for housing allowances		31,508	34,126
		<u>219,898</u>	<u>189,030</u>
Current liabilities			
Trade and other payables	16	545,253	514,623
Sales in advance of carriage		150,957	132,394
Current income tax liabilities		2,356	2,436
Short-term bank loans – unsecured		20,324	25,371
		<u>718,890</u>	<u>674,824</u>
Total liabilities		<u>938,788</u>	<u>863,854</u>
Total equity and liabilities		<u>4,345,549</u>	<u>4,241,903</u>
Net current assets		<u>2,081,663</u>	<u>691,843</u>
Total assets less current liabilities		<u>3,626,659</u>	<u>3,567,079</u>

UNAUDITED CONDENSED CONSOLIDATED STATEMENT OF RECOGNISED
INCOME AND EXPENSE

	Six months ended 30th June,	
	2006	2005
	<i>HK\$'000</i>	<i>HK\$'000</i>
Share of currency translation differences of associates	52	13
Share of fair value gains on derivative financial instruments of associates	22,130	23,897
Currency translation differences	387	–
	<hr/>	<hr/>
Net income recognised directly in equity	22,569	23,910
Profit for the period	39,270	131,654
	<hr/>	<hr/>
Total recognised income for the period	<u>61,839</u>	<u>155,564</u>
Attributable to:		
Equity holders of CNAC	66,053	146,820
Minority interests	(4,214)	8,744
	<hr/>	<hr/>
	<u>61,839</u>	<u>155,564</u>

UNAUDITED CONDENSED CONSOLIDATED CASH FLOW STATEMENT

	Six months ended 30th June,	
	2006	2005
	<i>HK\$'000</i>	<i>HK\$'000</i>
Net cash from operating activities	39,455	130,629
Net cash from investing activities	29,816	198,593
Net cash used in financing activities	<u>(38,174)</u>	<u>(90,809)</u>
Net increase in cash and cash equivalents	31,097	238,413
Cash and cash equivalents at 1st January	<u>999,833</u>	<u>746,793</u>
Cash and cash equivalents at 30th June	<u><u>1,030,930</u></u>	<u><u>985,206</u></u>
Analysis of balances of cash and cash equivalents:		
Cash at bank and in hand	425,988	350,823
Short-term bank deposits	706,162	709,010
Pledged bank deposits	<u>(101,220)</u>	<u>(74,627)</u>
	<u><u>1,030,930</u></u>	<u><u>985,206</u></u>

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL
INFORMATION**1. General information**

CNAC is a limited liability company incorporated in Hong Kong on 3rd February, 1997, the shares of which were listed on the Main Board of the Stock Exchange in December 1997. CNAC, its subsidiaries, its jointly controlled entities and its associates are principally engaged in the airline operations, airport ground handling services, airline catering services, logistics and other businesses.

The address of CNAC's registered office is 5th Floor, CNAC House, 12 Tung Fai Road, Hong Kong International Airport, Lantau.

This condensed consolidated financial information was approved for issue on 29th August, 2006.

2. Basis of preparation and accounting policies

This unaudited condensed consolidated financial information for the six months ended 30th June, 2006 ("Interim Financial Information") has been prepared in accordance with HKAS 34 "Interim Financial Reporting" issued by the HKICPA.

The Interim Financial Information should be read in conjunction with the annual financial statements for the year ended 31st December, 2005.

The principal accounting policies adopted are consistent with those of the annual financial statements for the year ended 31st December, 2005, except that as described in the annual financial statements for the year ended 31st December, 2005, the following new standards, amendments to standards and interpretations are mandatory for financial year ending 31st December, 2006.

HK(IFRIC)-Int 4 "Determining whether an Arrangement contains a Lease"

Amendments to HKAS 19 "Employee Benefits – Actuarial Gains and Losses, Group Plans and Disclosures"

Amendments to HKAS 39 "Financial Instruments: Recognition and Measurement":

- Cash Flow Hedge Accounting of Forecast Intragroup Transactions
- The Fair Value Option

Amendments, as a consequence of the Hong Kong Companies (Amendment) Ordinance 2005, to:

- HKAS 1 "Presentation of Financial Statements"
- HKAS 27 "Consolidated and Separate Financial Statements"
- HKFRS 3 "Business Combinations"

Amendments to HKAS 39 "Financial Instruments: Recognition and Measurement" and HKFRS 4 "Insurance Contracts" – "Financial Guarantee Contracts"

The adoption of HKAS 19 (Amendment) has resulted in a change in accounting policy in which the actuarial gains and losses for defined benefit pension plans are recognised in full in the year in which they occur, outside the income statement, in the statement of recognised income and expense. In prior years, actuarial gains and losses are recognised by amortising the amount by which cumulative unrecognised gains and losses exceed 10% of the greater of the assets of plan

and the defined benefit obligations over the average expected future working lifetime of the active members of the plan. The following is a summary of effect of adopting the HKAS 19 (Amendment) to the Interim Financial Information:

	30th June, 2006 <i>HK\$'000</i>	31st December, 2005 <i>HK\$'000</i>
Increase in interests in associates	24,860	24,860
Increase in retained profits	<u>24,860</u>	<u>24,860</u>

Other than above, there is no material change in the principal accounting policies or presentation of financial statements and there is no material impact as a result of the adoption of the remaining new standards, amendments to standards and interpretations on the Interim Financial Information.

The following new standards, amendments to standards and interpretations, which will be relevant to the CNAC Group, have been issued but are not effective for 2006 and have not been early adopted:

	Effective for accounting periods beginning on or after
HK(IFRIC)-Int 7 "Applying the Restatement Approach under HKAS 29"	1st March, 2006
HK(IFRIC)-Int 8 "Scope of HKFRS 2"	1st May, 2006
HK(IFRIC)-Int 9 "Reassessment of Embedded Derivatives"	1st June, 2006
HKFRS 7 "Financial Instruments: Disclosures"	1st January, 2007
Amendments to HKAS 1 "Presentation of Financial Statements: Capital Disclosures"	1st January, 2007

The CNAC Group has not early adopted the above standards, interpretations and amendments in the Interim Financial Information. The CNAC Group has already commenced an assessment of the related impact to the CNAC Group but is not yet in a position to state whether substantial changes to the CNAC Group's principal accounting policies and presentation of the financial statements will be resulted.

3. Turnover and segment information

Turnover

	Six months ended 30th June, 2006 <i>HK\$'000</i>	2005 <i>HK\$'000</i>
Traffic revenues		
– Passenger services	868,954	736,672
– Cargo and mail services	418,281	343,111
Airline catering revenue	<u>143,935</u>	<u>119,367</u>
	<u>1,431,170</u>	<u>1,199,150</u>

Primary reporting format – Business segments

The CNAC Group, its jointly controlled entities and its associates are organised into four main business segments including airline operation, airport ground handling, airline catering, logistics and other businesses.

An analysis of the CNAC Group's revenues, results, assets and liabilities by business segments is as follows:

	Six months ended 30th June, 2006				Total HK\$'000
	Airline operation HK\$'000	Airport ground handling HK\$'000	Airline catering HK\$'000	Logistics and other businesses HK\$'000	
Segment revenues	<u>1,291,020</u>	<u>-</u>	<u>143,935</u>	<u>-</u>	<u>1,434,955</u>
Segment results	<u>(21,659)</u>	<u>-</u>	<u>26,163</u>	<u>-</u>	<u>4,504</u>
Interest income					15,831
Unallocated costs					<u>(21,257)</u>
Operating loss					(922)
Finance costs					(504)
Share of profits less losses of associates	(18,760)	65,134	6,175	(2,469)	<u>50,080</u>
Profit before income tax					48,654
Income tax					<u>(9,384)</u>
Profit for the period					<u>39,270</u>
Capital expenditure	16,603	-	2,816	-	19,419
Depreciation	32,750	-	5,907	-	38,657
Amortisation	-	-	41	-	41
Reversal of provision for impairment of trade receivables	<u>(623)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(623)</u>

APPENDIX I
**FINANCIAL INFORMATION
RELATING TO THE CNAC GROUP**

	At 30th June, 2006				Total HK\$'000
	Airline operation	Airport ground handling	Airline catering	Logistics and other businesses	
	HK\$'000	HK\$'000	HK\$'000	HK\$'000	
Segment assets	1,238,411	–	490,043	–	1,728,454
Interests in associates	–	213,443	129,851	(29,639)	313,655
Assets classified as held for sale	1,369,264	–	–	–	1,369,264
Loans to associates	–	–	–	64,219	64,219
Unallocated assets					869,957
Total assets					<u>4,345,549</u>
Segment liabilities	817,300	–	107,794	–	925,094
Unallocated liabilities					13,694
Total liabilities					<u>938,788</u>
	Six months ended 30th June, 2005				Total HK\$'000
	Airline operation	Airport ground handling	Airline catering	Logistics and other businesses	
	HK\$'000	HK\$'000	HK\$'000	HK\$'000	
Segment revenues	<u>1,107,017</u>	<u>–</u>	<u>119,368</u>	<u>–</u>	<u>1,226,385</u>
Segment results	<u>5,477</u>	<u>–</u>	<u>16,354</u>	<u>–</u>	21,831
Interest income					6,783
Unallocated costs					(9,844)
Operating profit					18,770
Finance costs					(1,802)
Share of profits less losses of associates	54,337	62,761	4,998	(1,598)	120,498
Profit before income tax					137,466
Income tax					(5,812)
Profit for the period					<u>131,654</u>
Capital expenditure	9,069	–	2,106	–	11,175
Depreciation	31,887	–	5,594	–	37,481
Amortisation	9	–	40	–	49
Reversal of provision for impairment of trade receivables	<u>(790)</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>(790)</u>

APPENDIX I
**FINANCIAL INFORMATION
RELATING TO THE CNAC GROUP**

	At 31st December, 2005 (Restated)				Total HK\$'000
	Airline operation	Airport ground handling	Airline catering	Logistics and other businesses	
	HK\$'000	HK\$'000	HK\$'000	HK\$'000	
Segment assets	1,168,150	-	488,620	-	1,656,770
Interests in associates	1,365,917	188,807	123,676	(25,946)	1,652,454
Loans to associates	-	18,060	-	47,097	65,157
Unallocated assets					867,522
Total assets					<u>4,241,903</u>
Segment liabilities	741,313	-	115,658	-	856,971
Unallocated liabilities					6,883
Total liabilities					<u>863,854</u>

Secondary reporting format – Geographical segments

The CNAC Group and its jointly controlled entities operate in three main geographical areas including China mainland, Taiwan and other regions (mainly Macau, Thailand and Philippines). The airline operation business is mainly operated in places in China mainland, Taiwan and other regions. The airline catering business is operated in China mainland.

	Segment revenues Six months ended 30th June,		Segment results Six months ended 30th June,	
	2006	2005	2006	2005
	HK\$'000	HK\$'000	HK\$'000	HK\$'000
China mainland	648,442	551,830	21,890	(22,056)
Taiwan	665,503	607,474	(3,875)	77,695
Other regions	121,010	67,081	(13,511)	(33,808)
	<u>1,434,955</u>	<u>1,226,385</u>	4,504	21,831
Interest income			15,831	6,783
Unallocated cost			(21,257)	(9,844)
Operating (loss)/profit			<u>(922)</u>	<u>18,770</u>

The major revenue-earning assets of the CNAC Group are its aircraft fleet, all of which are registered in Macau. Since the CNAC Group's aircraft fleet is deployed flexibly across its route network, the Directors consider that there is no meaningful basis to allocating such assets to geographical segments.

The assets and capital expenditure of jointly controlled entities in respect of airline catering business are located in China mainland.

The assets and capital expenditure of the CNAC Group, other than those of jointly controlled entities and its aircraft fleet as mentioned in the above, are mainly located in Macau.

4. Operating (loss)/profit

The following items have been included in arriving at operating (loss)/profit:

	Six months ended 30th June,	
	2006 HK\$'000	2005 HK\$'000
Crediting		
Reversal of provision for impairment of trade receivables	623	790
Fair value gains on derivative financial instruments	<u>36,430</u>	<u>16,546</u>
Charging		
Amortisation of intangible assets	–	9
Amortisation of land use right	41	40
Cost of inventories expensed	74,093	67,361
Depreciation of property, plant and equipment	<u>38,657</u>	<u>37,481</u>

5. Finance costs

	Six months ended 30th June,	
	2006 HK\$'000	2005 HK\$'000
Interest expenses on short-term bank loans	<u>504</u>	<u>1,802</u>

6. Income tax

Hong Kong profits tax has been provided at the rate of 17.5% (six months ended 30th June, 2005: 17.5%) on the estimated assessable profit. Macau Complementary Tax has been provided at the rate of 12% (six months ended 30th June, 2005: 15.75%) on the estimated assessable profit for the period.

The CNAC Group has two jointly controlled entities in China mainland, namely BACL and SWACL. Pursuant to the Circular (2006) No. 40 issued by the Sichuan State Tax Bureau, the income tax rate of SWACL has increased from 15% to 18% with effect from 1st January, 2006 (six months ended 30th June, 2005: 15%). BACL is subject to the income tax rate of 27% (six months ended 30th June, 2005: 27%).

Taxation outside Hong Kong and Macau has been calculated on the estimated assessable profit for the period at the rates of taxation prevailing in the countries in which the CNAC Group operates.

	Six months ended 30th June,	
	2006 HK\$'000	2005 HK\$'000
Current income tax		
– Taxation outside Hong Kong and Macau	6,677	4,409
– Over provisions in prior years	(11)	(66)
Deferred income tax	<u>2,718</u>	<u>1,469</u>
Income tax	<u>9,384</u>	<u>5,812</u>

7. Interim dividend

	Six months ended 30th June,	
	2006	2005
	HK\$'000	HK\$'000
Interim dividend proposed of nil (six months ended 30th June, 2005: HK0.8 cent) per share	<u>–</u>	<u>26,501</u>

8. Earnings per Share

Basic

Basic earnings per Share is calculated by dividing the profit attributable to equity holders of CNAC by the weighted average number of Shares in issue during the period.

	Six months ended 30th June,	
	2006	2005
	HK\$'000	HK\$'000
Profit attributable to equity holders of CNAC	<u>43,484</u>	<u>122,910</u>
Weighted average number of shares in issue (thousands)	<u>3,312,680</u>	<u>3,312,680</u>
Basic earnings per Share (HK cents per Share)	<u>1.31</u>	<u>3.71</u>

Diluted

Diluted earnings per Share is calculated based on the profit attributable to the equity holders of CNAC and the weighted average number of Shares in issue during the period, after adjusting for the number of dilutive potential Shares deemed to be issued at no consideration as if all outstanding Options granted by CNAC had been exercised.

	Six months ended 30th June,	
	2006	2005
	HK\$'000	HK\$'000
Profit attributable to the equity holders of CNAC	----- 43,484	----- 122,910
Weighted average number of Shares in issue (thousands)	3,312,680	3,312,680
Adjustment for assumed conversion of Options (thousands)	<u>45,519</u>	<u>35,741</u>
Weighted average number of Shares for diluted earnings per Share (thousands)	<u>3,358,199</u>	<u>3,348,421</u>
Diluted earnings per Shares (HK cents per Shares)	<u>1.29</u>	<u>3.67</u>

9. Capital expenditure

	Goodwill HK\$'000	Others HK\$'000	Total intangible assets HK\$'000	Property, plant and equipment (notes (i) and (ii)) HK\$'000	Land use right HK\$'000
Six months ended 30th June, 2005					
Opening net book amount at					
1st January, 2005	529,240	9	529,249	495,786	2,355
Additions	-	-	-	11,175	-
Disposals	-	-	-	(139)	-
Amortisation/depreciation	-	(9)	(9)	(37,481)	(40)
	<u>529,240</u>	<u>-</u>	<u>529,240</u>	<u>469,341</u>	<u>2,315</u>
Six months ended 30th June, 2006					
Opening net book amount at					
1st January, 2006	529,240	-	529,240	471,692	2,274
Additions	-	-	-	19,419	-
Disposals	-	-	-	(1,457)	-
Depreciation/amortisation	-	-	-	(38,657)	(41)
	<u>529,240</u>	<u>-</u>	<u>529,240</u>	<u>450,997</u>	<u>2,233</u>

- (i) At 30th June, 2006, property, plant and equipment included buildings of net book amount of approximately HK\$35,216,000 (31st December, 2005: HK\$37,988,000) relating to the buildings of BACL situated on pieces of allocated land held by a related party. Air China, the immediate holding company of CNAC, is procuring to transfer those land from the related party to Air China in order to ensure Air China will legally and/or beneficially own the interests and benefits of such land. Air China agrees that BACL can continue to use the land at nominal consideration until such time Air China obtains the legal title of the land. A lease agreement would then be entered into between Air China and BACL for a term of up to 30th April, 2023 at a rent to be calculated on the basis of the original costs for obtaining such land use right. Accordingly, the Directors of CNAC did not take into account any losses and costs arising from the inability to use any land currently used by BACL in the preparation of the Interim Financial Information.

Air China has further agreed to complete, at its expense, the formal procedures for transferring the building ownership rights of part of the production facilities from Air China to BACL. Such part of the production facilities were agreed to be injected by Air China into BACL as part of its initial capital contribution when BACL was established. No lease agreement has been entered between BACL and Air China.

- (ii) At 30th June, 2006, property, plant and equipment included buildings of net book amount of approximately HK\$38,290,000 (31st December, 2005: HK\$39,866,000) relating to an inflight meals production building held by SWACL which was put into use in 2004. However, SWACL was advised by Chengdu Shuangliu International Airport on 7th August, 2003 that this new inflight meals production building is situated in an area where the extension of airport premises to be located. As a result, this inflight meals production building might need to be demolished on or before 2015.

The Directors of CNAC consider that this is only a suggestion proposed by Chengdu Shuangliu International Airport and so far SWACL has not received any formal notification from the relevant government authorities regarding this. Nevertheless, the Directors of CNAC consider that SWACL had obtained all necessary approvals before constructing this production building and they are confident that SWACL is able to receive fair compensations from Chengdu Shuangliu International Airport should SWACL be requested to demolish the production building. The Directors of CNAC consider that this matter is currently at a preliminary stage of development, accordingly, it is too early to consider any potential impact to SWACL and the CNAC Group.

10. Interests in associates

	30th June, 2006	Restated 31st December, 2005
	<i>HK\$'000</i>	<i>HK\$'000</i>
Dragonair (<i>note 13</i>)	–	1,365,917
Others	260,947	233,829
	<u>260,947</u>	<u>1,599,746</u>

The interests in associates include unamortised goodwill of HK\$52,708,000 (31st December, 2005: HK\$52,708,000).

11. Interests in jointly controlled entities

At 30th June, 2006, the CNAC Group's proportionate share of the assets, liabilities, revenues and expenses of the jointly controlled entities are as follows:

	30th June, 2006	31st December, 2005
	<i>HK\$'000</i>	<i>HK\$'000</i>
Non-current assets	134,168	137,247
Current assets	175,867	112,206
	<u>310,035</u>	<u>249,453</u>
Non-current liability	(31,508)	(34,126)
Current liabilities	(78,121)	(88,647)
	<u>(109,629)</u>	<u>(122,773)</u>
Net assets	<u>200,406</u>	<u>126,680</u>

	Six months ended 30th June,	
	2006	2005
	HK\$'000	HK\$'000
Revenues	143,935	119,368
Other gains	294	93
Operating expenses	(118,851)	(103,013)
Finance costs	(504)	(1,802)
	<hr/>	<hr/>
Profit before income tax	24,874	14,646
Income tax	(5,908)	(3,835)
	<hr/>	<hr/>
Net profit	<u>18,966</u>	<u>10,811</u>

12. Trade and other receivables

Trade and other receivables include trade receivables from third parties, immediate holding company, an associate and related companies. The credit terms granted to sales agents and other trade customers are ranging from 15 to 90 days. The age analysis of trade receivables is as follows:

	30th June,	31st December,
	2006	2005
	HK\$'000	HK\$'000
Within 31 days	199,804	194,210
31 – 60 days	23,637	20,414
61 – 90 days	11,480	8,882
Over 90 days	10,377	9,752
	<hr/>	<hr/>
	<u>245,298</u>	<u>233,258</u>

13. Assets classified as held for sale

On 8th June, 2006, CNAC entered into a conditional agreement with Cathay pursuant to which CNAC has agreed to dispose of the CNAC Group's entire interest in Dragonair, an associate of the CNAC Group, to Cathay at a consideration to be satisfied by a combination of the issue of 288,596,335 new shares by Cathay at an issue price of HK\$13.50 per share and cash consideration of approximately HK\$432,894,000. This transaction was approved by the shareholders in the extraordinary general meeting held on 22nd August, 2006.

Upon completion of this transaction, CNAC will hold 7.34% equity interests in Cathay and such interest will be classified as available-for-sale investment in the balance sheet and carried at fair value. At 30th June, 2006, the CNAC Group's interest in Dragonair is presented as assets classified as held for sale.

14. Cash and cash equivalents and pledged bank deposits

Cash and cash equivalents and pledged bank deposits include HK\$292,421,000 (31st December, 2005: HK\$250,442,000) which are denominated in Renminbi and are held by the CNAC Group and its jointly controlled entities with bank accounts operating in China mainland where exchange controls apply.

15. Share capital

	Number of Shares (Thousands)	HK\$'000
At 1st January, 2005 and 2006, 30th June, 2006	<u>3,312,680</u>	<u>331,268</u>

The authorised share capital of CNAC comprises of 4,000,000,000 Shares with a par value of HK\$0.1 per Share. All issued Shares are fully paid.

16. Trade and other payables

Trade and other payables include trade payables to third parties, an associate, a fellow subsidiary and related companies. The age analysis of trade payables is as follows:

	30th June, 2006 HK\$'000	31st December, 2005 HK\$'000
Within 31 days	193,450	191,664
31 – 60 days	43,502	47,243
61 – 90 days	27,548	17,038
Over 90 days	<u>10,647</u>	<u>9,674</u>
	<u>275,147</u>	<u>265,619</u>

17. Contingent liabilities

	30th June, 2006 HK\$'000	31st December, 2005 HK\$'000
Guarantee for banking facilities granted by bank to:		
– An associate	20,000	20,000
– A jointly controlled entity	<u>13,835</u>	<u>87,475</u>
	<u>33,835</u>	<u>107,475</u>

As of 30th June, 2006, the CNAC Group had given a guarantee to a bank for loan facilities granted to a jointly controlled entity of RMB32,250,000 (equivalent to approximately HK\$31,311,000). Loans of RMB30,000,000 (equivalent to approximately HK\$29,126,000) were drawdown by the jointly controlled entity at 30th June, 2006. The CNAC Group's proportionate share of bank loans of HK\$17,476,000 had been included in the condensed consolidated balance sheet at 30th June, 2006 (31st December, 2005: HK\$23,070,000).

18. Commitments

- (a) The CNAC Group is a party to an agreement with the "Consortium Partners" in respect of the "Project". The CNAC Group has 25% interest in the Project. The CNAC Group's attributable share of capital commitments in respect of the Project is approximately HK\$78,000,000 (31st December, 2005: HK\$78,000,000).

In the event of default of any of the Consortium Partners, the CNAC Group will be required to provide additional funds for the Project. The CNAC Group and the Consortium Partners have jointly given a guarantee to the Hong Kong Airport Authority in respect of their obligations to provide sufficient funding for the Project. Should the CNAC Group be required to perform its obligations under the guarantee in the event of default of all of the Consortium Partners, the maximum amount of the additional liabilities assumed, in addition to the CNAC Group's estimated share of capital commitments as disclosed above, would be approximately HK\$234,000,000 (31st December, 2005: HK\$234,000,000).

- (b) As at 30th June, 2006, the CNAC Group had committed to make additional capital contribution to a jointly controlled entity, Macau Asia Express Limited, with an aggregate amount of up to approximately HK\$58,491,000.

- (c) *Capital commitments*

The CNAC Group's attributable share of capital expenditure contracted for by the CNAC Group's jointly controlled entities at the balance sheet date but not yet incurred is as follows:

	30th June, 2006 HK\$'000	31st December, 2005 HK\$'000
Property, plant and equipment	<u>5,667</u>	<u>3,966</u>

19. Related party transactions

The CNAC Group is part of a larger group of companies under Air China and has extensive transactions and relationships with members of the Air China Group. Because of these relationships, it is possible that the terms of transactions between the CNAC Group and members of the Air China Group are not the same as those that would result from transactions with or among other related parties or wholly unrelated parties.

Air China is controlled by CNAH, a state-owned enterprise which is wholly owned by the PRC government. As CNAC is indirectly controlled by the PRC government, state-owned enterprises and their subsidiaries, in addition to the CNAC Group companies of Air China, directly or indirectly owned by the PRC government are also related parties of the CNAC Group.

A portion of the CNAC Group's business activities are conducted with other state-owned enterprises. For the purpose of related party transactions disclosure, the CNAC Group has identified, to the extent practicable, those corporate customers and suppliers which are state-owned enterprises based on their immediate ownership structure. It should be noted, however, that a substantial portion of the CNAC Group's business activities are conducted in the PRC and the influence of the PRC government in the Chinese economy is pervasive. In this regard, the PRC government indirectly holds interests in many companies. In addition, a portion of the CNAC Group's services provided are of a retail nature to end users, which include transactions with the employees of state-owned enterprises on corporate business, their key management personnel and close family members. Due to the vast volume and the pervasiveness of these transactions, the CNAC Group is unable to determine the aggregate amount of these transactions

for disclosure. Therefore, the revenue from provision of services disclosed below does not include retail transactions with these related parties. However, the CNAC Group believes that meaningful information in respect of related party transactions has been adequately disclosed.

The following is a summary of significant transactions carried out with related parties in the ordinary course of business for the six months ended 30th June, 2006:

(a) *Revenue, other gains and expenses*

	Six months ended 30th June,	
	2006	2005
	<i>HK\$'000</i>	<i>HK\$'000</i>
Revenue and other gains:		
Value of tickets sold to (<i>note i</i>):		
– Immediate holding company	1,511	–
– An associate	659	565
– Fellow subsidiaries	1,367	2,880
– Related companies	423	145
Lease of an aircraft to immediate holding company	–	24,940
Sales of goods (<i>note ii</i>):		
– Immediate holding company	73,084	60,475
– An associate	6,102	5,272
– A fellow subsidiary	–	80
– Related companies	1,924	1,366
– Other state-owned enterprises (<i>note x</i>)	11,258	8,058
Interest income from state-owned banks (<i>note x</i>)	<u>10,072</u>	<u>3,972</u>
Operating expenses:		
Management fee paid to fellow subsidiaries (<i>notes iii and iv</i>)	4,800	4,800
Landing, loading, parking and other airport charges paid to:		
– A fellow subsidiary (<i>note v</i>)	49,138	42,497
– Other state-owned enterprises (<i>note x</i>)	23,302	19,347
Ground handling costs paid to an associate (<i>note vi</i>)	66,890	63,731
Technical and ground handling costs paid to an associate (<i>note vii</i>)	1,157	1,983
Inflight meal services expenses paid to a related company (<i>note viii</i>)	29,430	24,528
Lease rental paid to fellow subsidiaries (<i>note ix</i>)	827	826
Fuel costs paid to other state-owned enterprises (<i>note x</i>)	50,007	34,200
Finance cost paid to state-owned banks (<i>note x</i>)	<u>504</u>	<u>1,802</u>

- (i) Air tickets were sold to the related ticket sales agents in accordance with the pricing policy of the CNAC Group.
- (ii) The inflight meal services rendered were charged at terms pursuant to agreements entered into by BACL and SWACL with relevant related parties.
- (iii) On 28th July, 2005, CNAC and CNACG, a fellow subsidiary, renewed the management services agreement with the same terms under the management services agreement dated 27th August, 2003. Pursuant to the renewed management services agreement, CNACG has agreed to provide secretarial, personnel, accounting and general office administrative services to the CNAC Group for a period of three years from 1st July, 2005 to 30th June, 2008 at a monthly fee of HK\$500,000.

- (iv) On 4th November, 2005, CNAC Macau and CNACAL, a fellow subsidiary, renewed the management services agreement with the same terms under the management services agreement dated 25th March, 2002. Pursuant to the agreement, CNACAL has agreed to provide general management services including but not limited to secretarial, personnel, accounting and general office administrative services to CNAC Macau for a period of three years from 25th March, 2005 to 24th March, 2008 at a monthly fee of HK\$300,000.
- (v) The airport related charges paid to ADA were by reference to the tariff published by the Macau Airport.
- (vi) The ground handling services rendered were charged at terms pursuant to agreements entered into by the CNAC Group with Menzies Macau.
- (vii) The technical and ground handling services rendered were charged at terms pursuant to agreements entered into by the CNAC Group with Dragonair.
- (viii) The inflight meal services rendered were charged at terms pursuant to agreements entered into by the CNAC Group with Macau Catering Services Company Limited, a 34.5% owned associate held by a minority shareholder of Air Macau.
- (ix) The CNAC 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 CNAC Group at a monthly rental of MOP141,800 (equivalent to approximately HK\$138,000).
- (x) The above transactions with other state-owned enterprises and banks were entered into in accordance with the terms as set out in the agreements governing the transactions or as mutually agreed between the parties.
- (b) On 25th August, 2004, CNACG entered into two license agreements with CNAC pursuant to which CNACG has agreed to grant licenses to CNAC, free of royalty, for the rights to use those trademarks in Hong Kong and Macau, respectively, so long as CNAC is a direct or indirect subsidiary of CNAH ("License Agreements").

No royalty charge was levied under the License Agreements in respect of the use of these trademarks during the period.

(c) *Key management compensation*

	Six months ended 30th June,	
	2006 HK\$'000	2005 HK\$'000
Directors' fees	1,697	1,740
Salaries and other short-term employee benefits	3,720	3,778
	5,417	5,518
	5,417	5,518

- (d) Period-end balances arising from sales/purchases of goods/services with related parties comprised:

	30th June, 2006 <i>HK\$'000</i>	31st December, 2005 <i>HK\$'000</i>
Receivables from related parties		
Immediate holding company	38,108	29,412
An associate	2,218	1,088
A fellow subsidiary	–	240
Related companies	2,210	1,994
Other state-owned enterprises	6,528	6,145
	<u>49,064</u>	<u>38,879</u>
Bank deposits		
State-owned banks	<u>653,803</u>	<u>823,737</u>
Payables to related parties		
An associate	18,074	14,075
Fellow subsidiary	20,181	17,359
Related companies	5,159	4,583
Other state-owned enterprises	23,314	26,887
	<u>66,728</u>	<u>62,904</u>
Short-term bank loans		
State-owned banks	<u>20,324</u>	<u>25,371</u>

(C) INDEBTEDNESS STATEMENT**Borrowings and pledged deposits**

As at 30 September 2006, the CNAC Group and its jointly controlled entities had short-term bank loans denominated in Renminbi equivalent to approximately HK\$20 million, which are repayable within one year.

As at 30 September 2006, the CNAC Group's bank deposits of approximately HK\$101 million were mainly pledged for bank guarantees on aircraft leasing and financial derivative facilities granted to the CNAC Group.

Contingent Liabilities

As at 30 September 2006, the CNAC Group had given a guarantee to a bank for loan facilities granted to a jointly controlled entity of approximately HK\$31 million. Loans of approximately HK\$29 million were drawn down by the jointly controlled entity as at 30 September 2006. The CNAC Group's proportionate share of the bank loans of approximately HK\$17 million had been included in the indebtedness above.

Disclaimer

Except as disclosed above, as at 30 September 2006, the CNAC Group did not have any outstanding mortgages, bank overdrafts, loans, charges, guarantees, other similar indebtedness or other material contingent liabilities.

1. RESPONSIBILITY STATEMENT

The information in this document relating to the CNAC Group has been supplied by the directors of CNAC. The issue of this document has been approved by the directors of CNAC, who jointly and severally accept full responsibility for the accuracy of the information contained in this document relating to the CNAC Group and confirm, having made all reasonable enquiries, that to the best of their knowledge, opinions expressed in this document relating to the CNAC Group have been arrived at after due and careful consideration, and there are no other facts relating to the CNAC Group not contained in this document the omission of which would make any statement in this document in relation to the CNAC Group misleading.

The information in this document relating to the Air China Group (other than the CNAC Group) has been supplied by the directors of Air China. The issue of this document has been approved by the directors of Air China, who jointly and severally accept full responsibility for the accuracy of the information contained in this document (other than that relating to the CNAC Group) and confirm, having made all reasonable enquiries, that to the best of their knowledge, opinions expressed in this document (other than those expressed by the CNAC Board) have been arrived at after due and careful consideration, and there are no other facts (other than those relating to the CNAC Group) not contained in this document the omission of which would make any statement in this document (other than those relating to the CNAC Group) misleading.

2. SHARE CAPITAL

No Shares were issued by CNAC between 31 December 2005, being the end of the last financial year of CNAC, and the Latest Practicable Date.

The authorized and issued share capital of CNAC as at the Latest Practicable Date were as follows:

	<i>HK\$</i>
<i>Authorized:</i>	400,000,000
<i>Issued and fully paid up:</i>	331,268,000

All Shares rank *pari passu* in all respects as regards to the rights to dividend, voting and return of capital.

The Shares are listed and traded on the Stock Exchange. None of the Shares is listed, or dealt in, on any other stock exchange, nor is any listing of or permission to deal in the Shares being, or proposed to be, sought on any other stock exchange.

As at the Latest Practicable Date, there were 104,378,000 outstanding Options granted on 25 July 2003 and which are exercisable during the period from 26 October 2003 to 25 October 2009 at an exercise price of HK\$1.14 per Share.

As at the Latest Practicable Date, no Minority Shareholder had irrevocably committed to accept or reject the privatization proposal.

Save as aforesaid, as at the Latest Practicable Date, there were no other outstanding Shares or securities convertible into or warrants or options to subscribe for or derivatives relating to the Shares in issue.

3. DISCLOSURE OF INTERESTS

(a) Interests of Directors and Chief Executive

As at the Latest Practicable Date, apart from the interests of the directors of CNAC in the Options as disclosed below, none of the directors or chief executives of CNAC had any interests or short positions in the Shares, underlying shares or debentures of CNAC or any associated corporation (within the meaning of Part XV of the SFO) which (a) were required to be notified to CNAC and the Stock Exchange pursuant to Divisions 7 and 8 of Part XV of the SFO (including interests and short positions which they had taken or deemed to have taken under such provisions of the SFO); or (b) were required, pursuant to Section 352 of the SFO, to be entered in the register referred to therein; or (c) were required, pursuant to the Model Code for Securities Transactions by Directors of Listed Issuers, to be notified to CNAC and the Stock Exchange.

Name of Option holder	Number of Options	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:	<u>104,378,000</u>			

(b) Interests of Substantial Shareholders

Save as disclosed below, the directors of CNAC and the chief executives of CNAC are not aware of any person who, as at the Latest Practicable Date, had an interest or short position in the Shares and underlying shares (including Options) of CNAC which would fall to be disclosed to CNAC under Divisions 2 and 3 of Part XV of the SFO.

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

Notes:

1. A state-owned enterprise established in the PRC. It owned approximately 51.67% of the total issued share capital of Air China and the entire issued share capital of China National Aviation Corporation (Group) Limited, being a company incorporated in Hong Kong holding approximately 11.27% of the total issued capital of Air China. Accordingly its interests in CNAC duplicated those interests of Air China.
2. China National Aviation Corporation (Group) Limited, CNAC's former immediate controlling shareholder, transferred its approximately 69% shareholding interest in CNAC to Air China in September 2004 by way of a capital contribution in return for Air China's non-H foreign shares. As such Air China became the immediate controlling shareholder of CNAC. Air China's interest in CNAC duplicated those interests of China National Aviation Holding Company.
3. 5.6% of the interest of Best Strikes Limited in CNAC were held through these 7 companies. Thus, of the 9.7% interest of each of these companies, 5.6% duplicated Best Strikes Limited's interest in CNAC. The 9.7% interest of each of these companies in CNAC also duplicated each other.

4. ARRANGEMENTS AFFECTING DIRECTORS OF CNAC

As at the Latest Practicable Date:

- (i) no benefit (other than statutory compensation) was or would have been given by CNAC to any of its directors as compensation for loss of office or otherwise in connection with the privatization proposal;
- (ii) save for the proposal by Air China for the cancellation of the outstanding Options to be made to the holders of such Options, all of whom are executive directors of CNAC, at the price of HK\$1.66 per Option and the undertakings of such holders pertaining to the proposal of Air China as disclosed in the section entitled "Summary of the Proposal" in the Explanatory Statement on pages 33 to 35 of this document, there was no agreement or arrangement existing between any director of CNAC and any other person which would be conditional on, or dependent upon, the outcome of the Scheme or otherwise in connection with the privatization proposal; and
- (iii) there was no material contract entered into by CNAC in which any director of CNAC had a material personal interest.

5. DIRECTORS' SERVICE CONTRACTS

As at the Latest Practicable Date, none of the directors of CNAC had entered into, or was proposing to enter into, any service contract with CNAC or any of its subsidiaries or associated companies (as defined in the Takeovers Code) which are continuous with a notice period of 12 months or more, or had more than 12 months to run irrespective of notice period or which was entered into or amended within six months prior to 8 June 2006, being the date when a possible privatization of CNAC by Air China was first announced.

6.(a) DEALINGS BY CNAC AND ITS DIRECTORS IN AIR CHINA SHARES

As at the Latest Practicable Date, CNAC was not interested in the issued capital of Air China; nor had CNAC dealt for value in the shares of Air China or convertible securities, warrants, options or derivatives in respect of the shares of Air China during the period commencing six months prior to 8 June 2006, being the date when a possible privatization of CNAC by Air China was first announced, and ending on the Latest Practicable Date.

As at the Latest Practicable Date, no director of CNAC was interested in the issued share capital of Air China; nor had any such director dealt for value in the shares of Air China or convertible securities, warrants, options or derivatives in respect of the shares of Air China during the period commencing six months prior to 8 June 2006, being the date when a possible privatization of CNAC by Air China was first announced, and ending on the Latest Practicable Date.

6.(b) INTERESTS OF AIR CHINA DIRECTORS IN CNAC SHARES

As at the Latest Practicable Date, none of the directors of Air China was interested in the issued share capital of CNAC.

7. OTHER SHAREHOLDINGS AND DEALINGS

As at the Latest Practicable Date:

- (i) save as disclosed in Section 15 below headed “Experts” of this Appendix, no Shares were owned or controlled by any of the subsidiaries of CNAC, any pension fund of CNAC or of any of its subsidiaries or any adviser to CNAC; nor had any of such subsidiaries, pension funds or advisers dealt for value in the Share or convertible securities, warrants, options or derivatives in respect of the Shares during the period commencing on 8 June 2006, being the date when a possible privatization of CNAC by Air China was first announced, and ending on the Latest Practicable Date;
- (ii) no person had any arrangement of the kind referred to in Note 8 to Rule 22 of the Takeovers Code with (a) CNAC or any person who was an associate of CNAC or Air China by virtue of class (1) or (2) or (3) or (4) of the definition of “associate” under the Takeovers Code or (b) Air China or any person acting in concert with Air China, or (c) any other person during the period commencing on 8 June 2006, being the date when a possible privatization of CNAC by Air China was first announced, and ending on the Latest Practicable Date;
- (iii) no Shares were managed on a discretionary basis by any fund managers (other than exempt fund managers) connected with CNAC or Air China; nor had any of such fund managers dealt for value in the Shares or convertible securities, warrants, options or derivatives in respect of the Shares during the period commencing on 8 June 2006, being the date when a possible privatization of CNAC by Air China was first announced, and ending on the Latest Practicable Date; and
- (iv) there was no agreement or arrangement or understanding existing between Air China or any person acting in concert with Air China and any other person for the transfer of the beneficial interests in the Scheme Shares under the Scheme, and there was no intention to enter into any such agreement, arrangement or understanding.

8. SHAREHOLDINGS OF AND SHARE DEALINGS BY AIR CHINA AND PARTIES ACTING IN CONCERT WITH AIR CHINA IN CNAC

As at the Latest Practicable Date, Air China, together with Merrill Lynch PF&S as a party acting in concert with Air China, was interested in a total of 2,264,642,000 Shares, representing approximately 68.4% of the existing issued share capital of CNAC.

Air China did not deal for value in the Shares or convertible securities, warrants, options or derivatives in respect of the Shares during the period commencing six months prior to 8 June 2006, being the date when a possible privatization of CNAC by Air China was first announced, and ending on the Latest Practicable Date.

Merrill Lynch PF&S, which is under the same control as Merrill Lynch, one of the exclusive financial advisers to Air China, is presumed to be acting in concert with Air China in respect of the Scheme, sold 2,000 Shares on 1 June 2006 at an average price of US\$0.27 per Share and retained 14,000 Shares as at the Latest Practicable Date, which will be cancelled pursuant to the Scheme.

Save as disclosed above and in Section 3 above headed “Disclosure of Interests” of this Appendix in respect of the Options held by Mr. Zhang Xianlin, none of the parties acting in concert with Air China (including, without limitation, the directors of Air China), owned, controlled or dealt for value in the Shares or convertible securities, warrants, options or derivatives in respect of the Shares during the period commencing six months prior to 8 June 2006, being the date when a possible privatization of CNAC by Air China was first announced, and ending on the Latest Practicable Date.

9. RULE 25 OF THE TAKEOVERS CODE

As at the Last Trading Date, Cathay held an approximately 1.953% interest in CNAC. Under Rule 25 of the Takeovers Code, Air China as the offeror in the privatization proposal was precluded from making arrangements with any shareholder of CNAC which arrangements contained favourable conditions that would not be extended to all of the other shareholders of CNAC. Given that some of the transactions contemplated in the Restructuring Agreement such as the subscription by Cathay of H shares in Air China and the acquisition by Cathay of the shares in Dragonair from CNAC might constitute arrangements prohibited by Rule 25, Cathay has disposed of its entire shareholding in CNAC through donations to various independent charitable bodies of its shares in CNAC or, in one case, the proceeds of the sale of such shares. Accordingly, Cathay has ceased to be a shareholder of CNAC since 11 October 2006.

10. ARRANGEMENTS IN CONNECTION WITH THE PROPOSAL

As at the Latest Practicable Date:

- (i) no benefit other than statutory compensation was or would have been given by Air China to any director of CNAC as compensation for loss of office or otherwise in connection with the privatization proposal; and
- (ii) save for the proposal by Air China for the cancellation of the outstanding Options made to the holders of such Options, all of whom executive directors of CNAC, at the price of HK\$1.66 per Option and the undertakings of such holders relating to the proposal of Air China as disclosed in the section entitled “Summary of the Proposal” in the Explanatory Statement on pages 33 to 35 of this document, there was no agreement or arrangement or understanding, including any statutory compensation arrangement, existing between Air China or any person acting in concert with Air China and any of the directors of CNAC, recent directors of CNAC, the shareholders of CNAC or the recent shareholders of CNAC having any connection with or dependence upon the privatization proposal, and there was no intention to enter into any such agreement or arrangement or understanding.

11. MARKET PRICES

The Shares are traded on the Stock Exchange. The table below shows the respective closing prices of the Shares quoted on the Stock Exchange (i) on the last trading day of each of the calendar months during the period commencing six months preceding 8 June 2006, being the date when a possible privatization of CNAC by Air China was first announced, and ending on the Latest Practicable Date; (ii) on 2 June 2006, being the Last Trading Day; (iii) on 20 June 2006, being the last trading day immediately prior to the date of the Announcement; and (iv) on the Latest Practicable Date:

Date	Closing price <i>HK\$</i>
30 December 2005	1.520
27 January 2006	1.480
28 February 2006	1.560
31 March 2006	1.840
28 April 2006	1.920
30 May 2006	1.930
2 June 2006	1.970
20 June 2006	2.625
30 June 2006	2.700
31 July 2006	2.710
31 August 2006	2.750
29 September 2006	2.750
31 October 2006	2.760
Latest Practicable Date	2.760

The highest and lowest closing prices per Share recorded on the Stock Exchange during the period between 8 December 2005, being the day falling six months prior to the date when a possible privatization of CNAC by Air China was first announced, and the Latest Practicable Date were HK\$2.780 on 6 November 2006 and 7 November 2006 and HK\$1.400 on 13 December 2005, 15 December 2005 and 16 December 2005.

12. MATERIAL CONTRACTS

The following material contracts, not being contracts entered into in the ordinary course of business of the CNAC Group, were entered into by members of the CNAC Group during the period commencing on the date two years immediately prior to the date of the Announcement to the Latest Practicable Date:

- (a) Two sale and purchase agreements were entered into by Fly Top Limited, a wholly-owned subsidiary of CNAC, on 19 August 2004 for the acquisition of 16% and 4.2% equity interests in LSG Lufthansa Service Hong Kong Limited respectively from China National Aviation Corporation (Group) Limited at a consideration of HK\$89 million and Hong Kong International Air Catering Limited at HK\$24.5 million.

- (b) An aircraft wet lease agreement was entered into between Air Macau and Air China on 15 March 2005 pursuant to which Air Macau leased an aircraft to Air China at a monthly fee of US\$358,500 (equivalent to approximately HK\$2,796,000) with maintenance hourly charge of US\$470 (equivalent to approximately HK\$4,000) per block hour for the period from 20 October 2004 to 19 April 2005. The lease agreement was extended by a wet lease extension agreement entered into by the same parties on 13 April 2005 for the period from 20 April 2005 to 19 October 2005.
- (c) A project management services agreement was entered into between Beijing Air Catering Co. Ltd., a subsidiary of CNAC, and Air China Beijing Construction Base Command Centre on 4 November 2005 whereby Air China Beijing Construction Base 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 in return for Beijing Air Catering Co. Ltd. paying a management fee equivalent to 2.5% of the approved budget for the construction of the project.
- (d) On 24 January 2006, China National Aviation Corporation (Macau) Company Limited, a wholly-owned subsidiary of CNAC, Shun Tak Air Transport Limited and Groupax Limited entered into a joint venture agreement in relation to the establishment, management and operation of Groupax Limited. The aggregate initial investment for all parties in Groupax Limited was approximately HK\$114,660,000. On the same day, China National Aviation Corporation (Macau) Company Limited, Air Macau, Starpax Limited, Airpax Limited and Macau Asia Express Limited also entered into another joint venture agreement in relation to the establishment, management and operation of Macau Asia Express Limited for the purpose of operating low cost model air transport services based in Macau. The aggregate initial investment for all parties in Macau Asia Express Limited was approximately HK\$234,000,000.
- (e) The Restructuring Agreement.
- (f) On 8 June 2006, CNAC, Air China, CITIC Pacific Limited and Swire Pacific Limited entered into a shareholders' agreement for the purpose of regulating their relationship as shareholders of Cathay following completion of the Restructuring Agreement.

13. MATERIAL LITIGATION

As at the Latest Practicable Date, neither CNAC nor any of its subsidiaries was a defendant in any litigation of material importance, and no litigation or claim of material importance was known to the directors of CNAC to be pending or threatened by or against CNAC or any of its subsidiaries.

14. MATERIAL CHANGE

Save as disclosed on pages 108 and 109 of this document under Section III headed "Events after the Balance Sheet Date" in Appendix I, as at the Latest Practicable Date, the directors of CNAC were not aware of any material change in the financial or trading position or outlook of the CNAC Group since 31 December 2005, being the date to which the latest published audited accounts of the CNAC Group were made up.

15. EXPERTS

The following are the qualifications of the experts which have given opinions or advice contained in this document:

Name	Qualification
Citigroup	a corporation licensed under the SFO to conduct types 1, 4, 6 and 7 of the regulated activities
CLSA	a corporation licensed under the SFO to conduct types 4 and 6 of the regulated activities.

As at the Latest Practicable Date, CLSA Capital Limited, a company under the same control as CLSA, is interested in 1,970,000 Shares.

CLSA Capital Limited had the following dealings in the Shares during the period commencing on 8 June 2006, being the date when a possible privatization of CNAC by Air China was first announced, and ending on the Latest Practicable Date:

Date	Buy Number of Shares	Sell Number of Shares	Price paid/ received for each Share (HK\$)
9 June 2006	500,000	–	2.575
14 June 2006	3,000,000	–	2.625
14 June 2006	–	3,000,000	2.600
15 June 2006	1,500,000	–	2.650
15 June 2006	–	750,000	2.625

Since CLSA was only appointed to act as CNAC's independent financial adviser on 20 June 2006, the above dealings in the Shares represented dealings that occurred before the time CLSA was appointed as CNAC's independent financial adviser.

16. CONSENTS

Each of Citigroup and CLSA has given and has not withdrawn its written consent to the issue of this document with the inclusion herein of its opinion, letter and report, as the case may be, and references to its name in the form and context in which they respectively appear in this document. Each of CICC and Merrill Lynch has given and has not withdrawn its written consent to the issue of this document with the references to its name in the form and context in which they respectively appear in this document.

17. GENERAL

- (i) The registered address and the head office of CNAC are situate at 5th Floor, CNAC House, 12 Tung Fai Road, Hong Kong International Airport, Lantau, Hong Kong.
- (ii) The principal office of Air China is situate at 9th Floor Blue Sky Mansion, 28 Tianzhu Road Zone A, Tianzhu Airport Ind Zone, Shunyi District, Beijing, PRC.
- (iii) The company secretary of CNAC is Mr. Li Man Kit, ACIS, ACS.
- (iv) The qualified accountant of CNAC appointed pursuant to Rule 3.24 of the Listing Rules is Mr. Ng Wai Shun, Johnson, CPA, FCCA, ACIS, ACS.
- (v) CNAC's share registrar and transfer office is Computershare Hong Kong Investor Services Limited, 17th Floor, Hopewell Centre, 183 Queen's Road East, Hong Kong.
- (vi) The principal office of Citigroup is situate at 50th Floor, Citibank Tower, Citibank Plaza, 3 Garden Road, Central, Hong Kong.
- (vii) The principal office of CICC is situate at Suite 2307, 23rd Floor, One International Finance Centre, 1 Harbour View Street, Central, Hong Kong.
- (viii) The principal office of Merrill Lynch is situate at 17th Floor, ICBC Tower, 3 Garden Road, Central, Hong Kong.
- (ix) The principal office of Merrill Lynch PF&S is situate at 4 World Financial Centre, New York NY 10080, United States of America.

- (x) The directors of Air China, as at the date of this document, are Li Jiayang, Kong Dong, Wang Shixiang, Yao Weiting, Christopher Dale Pratt, Ma Xulun, Cai Jianjiang, Fan Cheng, Hu Hung Lick, Henry, Wu Zhipan, Zhang Ke and Jia Kang.
- (xi) The ultimate controlling shareholder of Air China is China National Aviation Holding Company, a company established under the laws of the PRC. China National Aviation Holding Company does not have a board of directors.
- (xii) The English text of this document and the accompanying forms of proxy shall prevail over the Chinese text in the event of any inconsistency.

18. DOCUMENTS AVAILABLE FOR INSPECTION

Copies of the following documents are available for inspection at the registered office of CNAC at 5th Floor, CNAC House, 12 Tung Fai Road, Hong Kong International Airport, Lantau, Hong Kong during normal business hours on weekdays other than public holidays from the date of this document until the Effective Date or the day on which the Scheme lapses or is withdrawn, whichever is the earliest:

- (i) the memorandum and articles of association of CNAC;
- (ii) the memorandum and articles of association of Air China;
- (iii) the circular issued by CNAC dated 30 June 2006 in connection with the sale of the CNAC Group's entire interest in Dragonair and the acquisition of shares in Cathay;
- (iv) the form of the letter from Air China to the holders of the Options in connection with the proposal for the cancellation of the outstanding Options at the price of HK\$1.66 per Option;
- (v) the letter from the Independent Board Committee, the text of which is set out on page 12 of this document;
- (vi) the letter from CLSA, the text of which is set out on pages 13 to 31 of this document;
- (vii) the material contracts referred to in Section 12 of this Appendix;
- (viii) the letter of undertaking from each of Messrs. Zhang Xianlin, Gu Tiefei, Chuang Shih Ping and Tsang Hing Kwong, Thomas to CNAC and Air China in relation to the Options held by them;

- (ix) the letter of undertaking from Air China to CNAC in relation to the Shares held by it referred to in the Scheme on page 145 of this document;
- (x) the letter of undertaking from each of Merrill Lynch PF&S and Merrill Lynch International in relation to the Shares held by them referred to in the Scheme on page 145 of this document; and
- (xi) the letters of consent referred to in Section 16 of this Appendix.

Copies of the documents listed above are also available for inspection on the website of CNAC at <http://www.hk1110.com> and on the website of the SFC at <http://www.sfc.hk>.

SCHEME OF ARRANGEMENT

HCMP NO. 2290/06

IN THE HIGH COURT OF
THE HONG KONG SPECIAL ADMINISTRATIVE REGION
COURT OF FIRST INSTANCE
MISCELLANEOUS PROCEEDINGS NO. 2290 OF 2006

In the Matter of
CHINA NATIONAL AVIATION COMPANY LIMITED
(中航興業有限公司)

and

In the Matter of
the COMPANIES ORDINANCE

Chapter 32 of the Laws of the Hong Kong Special Administrative Region

SCHEME OF ARRANGEMENT

(under Section 166 of the Companies Ordinance,
Chapter 32 of the Laws of the Hong Kong Special Administrative Region)
between

CHINA NATIONAL AVIATION COMPANY LIMITED
(中航興業有限公司)

and

the holders of the Scheme Shares (as defined below)

PRELIMINARY

(A) In this Scheme of Arrangement, unless inconsistent with the subject or context, the following expressions shall have the meanings respectively set opposite them:

“Air China”

Air China Limited (中國國際航空股份有限公司), a company incorporated in the People’s Republic of China and the shares of which are listed on the Main Board of The Stock Exchange of Hong Kong Limited, the Shanghai Stock Exchange and the London Stock Exchange

“Air China Group”

Air China and its subsidiaries

SCHEME OF ARRANGEMENT

“CNAC”	China National Aviation Company Limited (中航興業有限公司), a company incorporated in Hong Kong with limited liability and the Shares are listed on the Main Board of The Stock Exchange of Hong Kong Limited
“Court”	High Court of Hong Kong
“Effective Date”	the date on which this Scheme becomes effective in accordance with Clause 6 of this Scheme
“HK\$”	Hong Kong dollars, the lawful currency of Hong Kong
“holder(s)”	registered holder(s), including person(s) entitled by transmission to be registered as such and joint holders
“Hong Kong”	Hong Kong Special Administrative Region of the People’s Republic of China
“Latest Practicable Date”	13 November 2006, being the latest practicable date prior to the printing of the document containing this Scheme for the purpose of ascertaining certain information for inclusion herein
“Merrill Lynch International”	Merrill Lynch International, a private company incorporated under the laws of England and Wales with unlimited liability
“Merrill Lynch PF&S”	Merrill Lynch, Pierce, Fenner & Smith Incorporated, a company incorporated in the United States of America with limited liability
“Record Time”	4:00 p.m. Hong Kong time on a day on which The Stock Exchange of Hong Kong Limited is open for trading of securities and immediately preceding the Effective Date
“Scheme”	this scheme of arrangement in its present form or with or subject to any modification thereof or addition thereto or conditions approved or imposed by the Court

SCHEME OF ARRANGEMENT

“Scheme Share(s)”	Share(s) in issue at the Record Time
“Shares”	ordinary shares of HK\$0.10 each in the capital of CNAC

- (B) The authorized capital of CNAC is HK\$400,000,000, divided into 4,000,000,000 Shares, of which 3,312,680,000 Shares have been issued and are fully paid.
- (C) The purpose of this Scheme is that all of the Scheme Shares shall be cancelled and that CNAC will become a private company within the Air China Group.
- (D) As at the Latest Practicable Date, Air China was the registered and beneficial owner of 2,264,628,000 Shares, representing 68.4% of the issued capital of CNAC. Air China has undertaken to CNAC that:
- (i) in relation to such Shares, Air China would remain so beneficially interested and registered until the Scheme had become effective, been withdrawn or lapsed; and
 - (ii) in respect of any options granted by CNAC for the subscription of the Shares which would remain unexercised at the time of the hearing by the Court of the petition to sanction this Scheme, Air China would, subject to this Scheme becoming effective, make an offer to the holders of all such options to surrender their rights in respect of the options to CNAC for cancellation at the price of HK\$ 1.66 per option.
- (E) Further, as at the Latest Practicable Date, Merrill Lynch PF&S was the registered and beneficial owner of 14,000 Shares. As a company under the same ultimate control as one of the financial advisers to Air China in relation to this Scheme, Merrill Lynch PF&S is presumed to be acting in concert with Air China under the Code on Takeovers and Mergers and has accordingly undertaken to CNAC that in relation to such Shares, Merrill Lynch PF&S would remain so beneficially interested and registered until the Scheme had become effective, been withdrawn or lapsed and that such Shares would neither be represented nor voted at the meeting convened by direction of the Court for the purpose of approving this Scheme.
- (F) Further, as at the Latest Practicable Date, Merrill Lynch International was the registered and beneficial owner of 4,000 Shares. As an exempt principal trader connected with one of the financial advisers to Air China in relation to this Scheme, Merrill Lynch International is precluded by the Code on Takeovers and Mergers from voting in relation to the Scheme and has accordingly undertaken to CNAC that in relation to such Shares, Merrill Lynch International would remain so beneficially interested and registered until the Scheme had become effective, been withdrawn or lapsed and that such Shares would neither be represented nor voted at the meeting convened by direction of the Court for the purpose of approving this Scheme.

SCHEME OF ARRANGEMENT

- (G) Further, as at the Latest Practicable Date, there remained outstanding an aggregate of 104,378,000 options granted to and are held by and registered in the names of the following directors of CNAC for the subscription of 104,378,000 Shares at an exercise price of HK\$1.14 per Share:

Name of option holder	Number of options
Zhang Xianlin	33,126,000
Gu Tiefei	5,000,000
Chuang Shih Ping	33,126,000
Tsang Hing Kwong, Thomas	33,126,000
	104,378,000

Each of Zhang Xianlin and Gu Tiefei has undertaken to both CNAC and Air China that he would neither accept any of the offer of Air China for the cancellation of any of his options nor would he exercise any of his options on or before the expiry of the option period as stipulated in the share option scheme adopted by CNAC on 29 May 2002.

Each of Chuang Shih Ping and Tsang Hing Kwong, Thomas has also undertaken to both CNAC and Air China that in the event that any of the options in which he was interested should remain unexercised at the time of the hearing by the Court of the petition to sanction this Scheme, subject to the Scheme becoming effective, such options would not be exercised as from the time of such hearing by the Court and would forthwith be surrendered to CNAC for cancellation in consideration of the payment by Air China to him of the sum of HK\$1.66 per option.

- (H) Each of Air China, Merrill Lynch PF&S, Merrill Lynch International, Zhang Xianlin, Gu Tiefei, Chuang Shih Ping and Tsang Hing Kwong, Thomas has agreed to appear by Counsel at the hearing of the petition to sanction this Scheme and to undertake to the Court to be bound thereby and to execute and do and procure to be executed and done all such documents, acts and things as may be necessary or desirable to be executed or done by each of them respectively for the purpose of giving effect to this Scheme.

SCHEME OF ARRANGEMENT

THE SCHEME

PART I

Cancellation of the Scheme Shares

1. On the Effective Date:
 - (a) the authorized and issued capital of CNAC shall be reduced by cancelling and extinguishing the Scheme Shares;
 - (b) subject to and forthwith upon such reduction of capital taking effect, the authorized capital of CNAC shall be increased to its former amount by the creation of such number of new Shares as is equal to the number of the Scheme Shares cancelled; and
 - (c) CNAC shall apply the credit arising in its books of account as a result of the reduction of its capital referred to in paragraph (a) of this Clause 1 in paying up in full at par the new Shares to be created as aforesaid, which new Shares shall be allotted and issued, credited as fully paid, to Air China or such other party as Air China may direct.

PART II

Consideration for cancellation of the Scheme Shares

2. In consideration of the cancellation and extinguishment of the Scheme Shares, Air China shall pay or cause to be paid to the holders of the Scheme Shares (as appearing on the register of members of CNAC at the Record Time) the sum of HK\$2.80 for every Scheme Share held.

PART III

General

3. (a) Not later than 10 days after the Effective Date, Air China shall send or procure to be sent to the holders of the Scheme Shares (as appearing on the register of members of CNAC at the Record Time) cheques in respect of the sums payable to such holders pursuant to Clause 2 of this Scheme.

SCHEME OF ARRANGEMENT

- (b) Unless indicated otherwise in writing to the share registrar of CNAC, Computershare Hong Kong Investor Services Limited, at 17th Floor, Hopewell Centre, 183 Queen's Road East, Hong Kong, all such cheques shall be sent through the post in pre-paid envelopes addressed to the persons entitled thereto:
 - (i) in the case of each sole holder, to the registered address of such holder as appearing on the register of members of CNAC at the Record Time; or
 - (ii) in the case of joint holders, to the registered address as appearing on the register of members of CNAC at the Record Time of the joint holder whose name then stands first on the register of members of CNAC in respect of the relevant joint holding.
- (c) All cheques shall be posted at the risk of the addressees and other persons entitled thereto and neither Air China nor CNAC shall in any way be responsible for any loss or delay whatsoever in the transmission of such cheques.
- (d) Each such cheque shall be made payable to the order of the person to whom the envelope containing the same is addressed, and the encashment of any such cheque shall be a good discharge to Air China for the monies represented by such cheque.
- (e) On or after the day falling six calendar months after the posting of the cheques pursuant to paragraph (b) of this Clause 3, Air China shall have the right to cancel or countermand payment of any such cheque which has not then been encashed or has been returned uncashed, and shall place all monies represented by such cheques in a deposit account in CNAC's name with a licensed bank in Hong Kong to be selected by CNAC. CNAC shall hold such monies until the expiration of six years from the Effective Date and shall, prior to such day, make payments out of such monies of the sums payable pursuant to Clause 2 of this Scheme to persons who satisfy CNAC that they are respectively entitled to such sums and that the cheques of which they are payees have not been encashed. Any payments so made by CNAC shall include any interest accrued on the sums to which the respective persons are entitled pursuant to Clause 2 of this Scheme, calculated at the annual rate prevailing from time to time at the licensed bank in which the monies are deposited, subject (where applicable) to the deduction of any interest or withholding or other tax or any other deduction required by law and all expenses and costs incurred in relation to the payment.

SCHEME OF ARRANGEMENT

- (f) On the expiration of six years from the Effective Date, Air China shall be released from any further obligation to make any payments under this Scheme and CNAC shall transfer to Air China the balance, if any, of the sums standing to the credit of the deposit account referred to in paragraph (e) of this Clause 3, including accrued interest subject, if applicable, to the deduction of any interest or withholding or other tax or any costs and expenses incurred or to be incurred in effecting the transfer.
- (g) The preceding paragraphs of this Clause 3 shall take effect subject to any prohibition or condition imposed by law.
- 4. Each instrument of transfer and certificate validly subsisting at the Record Time in respect of a transfer or holding of any number of the Scheme Shares shall, on the Effective Date, cease to be valid for any purpose as an instrument of transfer or a certificate for such Scheme Shares and every holder of such certificate shall be bound at the request of CNAC to deliver up the same to CNAC for the cancellation thereof.
- 5. All mandates or relevant instructions to CNAC in force at the Record Time relating to any of the Scheme Shares shall cease to be valid as effective mandates or instructions.
- 6. This Scheme shall become effective as soon as an office copy of the Order of the Court sanctioning this Scheme under Section 166 of the Companies Ordinance, Chapter 32 of the Laws of the Hong Kong, and confirming, under Section 60 of the same Ordinance, the reduction of capital provided for in this Scheme, together with a minute relating to the share capital of CNAC and containing the particulars required by Section 61 of such Ordinance, shall have been duly registered by the Registrar of Companies.
- 7. Unless this Scheme shall have become effective on or before 10 April 2007 or such later date, if any, as the Court may allow, this Scheme shall lapse.
- 8. CNAC and Air China may jointly consent for and on behalf of all concerned to any modification of or addition to this Scheme or to any condition which the Court may think fit to approve or impose.
- 9. All costs, charges and expenses of and incidental to this Scheme and of carrying this Scheme into effect shall be borne by CNAC.

Dated 16 November 2006

NOTICE OF COURT MEETING

HCMP 2290/06

IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION
COURT OF FIRST INSTANCE
MISCELLANEOUS PROCEEDINGS NO. 2290 OF 2006

In the Matter
Of
CHINA NATIONAL AVIATION COMPANY LIMITED
(中航興業有限公司)
and
In the Matter
Of
the Companies Ordinance
Chapter 32 of the Laws of the Hong Kong Special Administrative Region

NOTICE OF COURT MEETING

NOTICE IS HEREBY GIVEN that, by an Order dated 14 November 2006 made in the above matters, the Court has directed a Meeting to be convened of the holders of the ordinary shares of HK\$0.10 each in the capital of the above-named China National Aviation Company Limited other than those shares held and registered in the name of Air China Limited for the purpose of considering and, if thought fit, approving (with or without modification) a Scheme of Arrangement proposed to be made between the Company and the aforementioned holders of the ordinary shares of HK\$0.10 each and that such Meeting will be held at Tianshan – Lushan Room, Level 5, Island Shangri-La, Hong Kong, Pacific Place, Supreme Court Road, Central, Hong Kong on Friday, 15 December 2006 at 11:00 a.m. at which place and time all such holders of ordinary shares of HK\$0.10 each in the capital of the Company are requested to attend.

A copy of the Scheme of Arrangement and a copy of the Explanatory Statement required to be furnished pursuant to Section 166A of the above-mentioned Ordinance are incorporated in the composite document of which this Notice forms part.

The above-mentioned holders of the ordinary shares of HK\$0.10 each in the capital of the Company may vote in person at the Meeting or they may appoint another person, whether a member of the Company or not, as their proxy to attend and vote in their stead. A pink form of proxy for use at the Meeting is enclosed herewith.

NOTICE OF COURT MEETING

It is requested that forms appointing proxies be lodged with the share registrar of the Company, Computershare Hong Kong Investor Services Limited, at 17th Floor, Hopewell Centre, 183 Queen's Road East, Hong Kong not less than 48 hours before the time appointed for the Meeting, but if forms are not so lodged they may be handed to the Chairman of the Meeting at the Meeting.

In the case of joint holders of a share, the vote of the senior who tenders a vote, whether in person or by proxy, will be accepted to the exclusion of the vote(s) of the other joint holder(s) and, for this purpose, seniority will be determined by the order in which the names stand on the register of members of the Company in respect of the relevant joint holding.

For the purpose of determining the entitlement to attend and vote at the Meeting, all properly executed instruments of transfer, together with the relevant share certificates, must be lodged with the share registrar of the Company not later than 4:00 p.m. on Tuesday, 12 December 2006.

By the same Order, the Court has appointed Li Kwok Heem, John or, failing him, Lok Kung Nam or, failing him, Chan Ching Har, Eliza to act as Chairman of the Meeting and has directed the Chairman to report the result thereof to the Court.

The Scheme of Arrangement will be subject to the subsequent approval of the Court.

Dated 16 November 2006

BAKER & MCKENZIE
14th Floor, Hutchison House
10 Harcourt Road
Central
Hong Kong

Solicitors for China National Aviation Company Limited

NOTICE OF EXTRAORDINARY GENERAL MEETING



中航興業有限公司

CHINA NATIONAL AVIATION COMPANY LIMITED

(incorporated in Hong Kong with limited liability)

(Stock Code: 1110)

NOTICE IS HEREBY GIVEN that an Extraordinary General Meeting of China National Aviation Company Limited will be held at Tianshan – Lushan Room, Level 5, Island Shangri-La, Hong Kong, Pacific Place, Supreme Court Road, Central, Hong Kong on Friday, 15 December 2006 at 11:30 a.m. (or so soon thereafter as the Meeting of the holders of the ordinary shares of HK\$0.10 each in the capital of the Company other than Air China Limited convened by direction of the High Court of the Hong Kong Special Administrative Region for the same place and date shall have been concluded or adjourned) for the purpose of considering and, if thought fit, passing the following resolution as a Special Resolution:

SPECIAL RESOLUTION

“THAT:

- (a) the Scheme of Arrangement dated 16 November 2006 (the “Scheme”) between the Company and the holders of the Scheme Shares (as defined in the Scheme) in the form of the print which has been produced to this Meeting and for the purpose of identification signed by the Chairman of this Meeting, with any modification thereof or addition thereto or condition approved or imposed by the High Court of the Hong Kong Special Administrative Region, be and is hereby approved;
- (b) for the purpose of giving effect to the Scheme, on the Effective Date (as defined in the Scheme):
 - (i) the authorized and issued capital of the Company be reduced by cancelling and extinguishing the Scheme Shares;
 - (ii) subject to and forthwith upon such reduction of capital taking effect, the authorized capital of the Company be increased to its former amount by the creation of such number of new ordinary shares of HK\$0.10 each in the capital of the Company as is equal to the number of the Scheme Shares cancelled; and

NOTICE OF EXTRAORDINARY GENERAL MEETING

- (iii) the Company shall apply the credit arising in its books of account as a result of such reduction of capital in paying up in full at par the new ordinary shares of HK\$0.10 each in the capital of the Company to be created as aforesaid, which new shares shall be allotted and issued, credited as fully paid, to Air China Limited or such other party as Air China Limited may direct, and the directors of the Company be and are hereby unconditionally authorized to allot and issue the same accordingly.”

By Order of the Board
China National Aviation Company Limited
Li Man Kit
Company Secretary

Hong Kong, 16 November 2006

Registered Office:

5th Floor
CNAC House
12 Tung Fai Road
Hong Kong International Airport
Lantau
Hong Kong

Notes:

- (1) Any member entitled to attend and vote at the meeting is entitled to appoint one or more proxies to attend and vote instead of him. A proxy need not be a member of the Company, but must attend the Meeting in person to represent him.
- (2) A white form of proxy for use at the Meeting is enclosed with this Notice.
- (3) In order to be valid, the white form of proxy, together with the power of attorney or other authority (if any) under which it is signed or a notarially certified copy of that power of attorney or authority, must be deposited with the share registrar of the Company, Computershare Hong Kong Investor Services Limited, at 17th Floor, Hopewell Centre, 183 Queen’s Road East, Hong Kong not less than 48 hours before the time fixed for holding the Meeting or any adjournment thereof.
- (4) Completion and return of the white form of proxy will not preclude a member from attending and voting in person at the Meeting if he so wishes. If such member attends the Meeting, however, his white form of proxy will be deemed to have been revoked.
- (5) In the case of joint holders of a share, the vote of the senior who tenders a vote, whether in person or by proxy, will be accepted to the exclusion of the vote or votes of the other joint holders and, for this purpose, seniority will be determined by the order in which the names stand on the register of members of the Company in respect of the relevant joint holding.