

Management Discussion and Analysis

During 2006, the Group's transport capacity and passenger volume and cargo carried was significantly increased as a result of the continuous growth in demand for domestic air transportation. On the other hand, the Group has strengthened the cost control strategy, particularly on saving jet fuel cost and repairs and maintenance expenses. Together with improving the allocation of transport capacity between peak and non peak season; expanding the routes that are profitable and enhancing the ticket revenue management system, the Group attempted to increase the revenue and the operation efficiency in 2006.

In April and September of 2006, the National Development and Reform Commission and the Civil Aviation Administration of China ("CAAC") approved to raise the passenger fuel surcharge for domestic routes which helped to relieve the soaring jet fuel cost.



OPERATING DATA SUMMARY

The following table sets forth certain financial information and operating data by geographic region:

	For the year ended 31 December		2006 vs 2005
	2006	2005	Increase/ (decrease) %
Traffic			
Revenue passenger kilometres (RPK) (million)			
– Domestic	58,128	51,472	12.9
– Hong Kong and Macau	1,541	1,549	(0.5)
– International	9,913	8,902	11.4
Total	69,582	61,923	12.4
Revenue tonne kilometres (RTK) (million)			
– Domestic	6,226	5,571	11.8
– Hong Kong and Macau	156	159	(1.9)
– International	1,689	1,554	8.7
Total	8,071	7,284	10.8

Management Discussion and Analysis (Cont'd)

OPERATING DATA SUMMARY (Cont'd)

	For the year ended 31 December		2006 vs 2005 Increase/ (decrease)
	2006	2005	%
Traffic (Cont'd)			
Passengers carried (thousand)			
– Domestic	44,225	39,545	11.8
– Hong Kong and Macau	1,545	1,556	(0.7)
– International	3,436	3,018	13.9
Total	49,206	44,119	11.5
Cargo and mail carried (thousand tonnes)			
– Domestic	674	639	5.5
– Hong Kong and Macau	16	19	(15.8)
– International	129	117	10.3
Total	819	775	5.7
Capacity			
Available seat kilometres (ASK) (million)			
– Domestic	79,773	72,107	10.6
– Hong Kong and Macau	2,459	2,656	(7.4)
– International	14,827	13,598	9.0
Total	97,059	88,361	9.8
Available tonne kilometres (ATK) (million)			
– Domestic	9,311	8,352	11.5
– Hong Kong and Macau	289	315	(8.3)
– International	3,056	2,842	7.5
Total	12,656	11,509	10.0

Management Discussion and Analysis (Cont'd)

OPERATING DATA SUMMARY (Cont'd)

	For the year ended 31 December		2006 vs 2005 Increase/ (decrease)
	2006	2005	%
Load factor			
Passenger load factor (RPK/ASK) (%)			
– Domestic	72.9	71.4	2.1
– Hong Kong and Macau	62.7	58.3	7.5
– International	66.9	65.5	2.1
Overall	71.7	70.1	2.3
Overall load factor (RTK/ATK) (%)			
– Domestic	66.9	66.7	0.3
– Hong Kong and Macau	54.0	50.4	7.1
– International	55.3	54.7	1.1
Overall	63.8	63.3	0.8
Yield			
Yield per RPK (RMB)			
– Domestic	0.59	0.55	7.3
– Hong Kong and Macau	0.80	0.77	3.9
– International	0.62	0.56	10.7
Overall	0.60	0.55	9.1
Yield per RTK (RMB)			
– Domestic	5.74	5.30	8.3
– Hong Kong and Macau	8.52	8.18	4.2
– International	4.77	4.24	12.5
Overall	5.59	5.14	8.8

Management Discussion and Analysis (Cont'd)

OPERATING DATA SUMMARY (Cont'd)

	For the year ended 31 December		2006 vs 2005 Increase/ (decrease)
	2006	2005	%
Fleet			
Total number of aircraft at year end			
– Boeing	159	140	13.6
– Airbus	103	71	45.1
– McDonnell Douglas	36	36	–
– Others	11	14	(21.4)
Total	309	261	18.4
Overall utilisation rate (hours per day)			
– Boeing	10.0	10.1	(1.0)
– Airbus	9.3	9.3	–
– McDonnell Douglas	8.4	8.9	(5.6)
Overall	9.5	9.6	(1.0)
Cost			
– Operating cost per ASK (RMB)	0.47	0.45	4.4
– Operating cost per ATK (RMB)	3.63	3.44	5.5

Management Discussion and Analysis (Cont'd)

FINANCIAL PERFORMANCE

The profit attributable to equity shareholders of the Company for 2006 is RMB188 million, as compared to a loss of RMB1,848 million for 2005. The scale of operations increased as a result of steady growth in China's economy and strong demand for air transportation. The Group's operating revenue increased by RMB7,926 million or 20.7% from RMB38,293 million in 2005 to RMB46,219 million in 2006. Passenger load factor increased by 1.6 percentage point from 70.1% in 2005 to 71.7% in 2006. Passenger yield (in passenger revenue per RPK) increased by 9.1% to RMB0.60. Average yield (in traffic revenue per RTK) increased by 8.8% from RMB5.14 in 2005 to RMB5.59 in 2006. Operating expenses increased by RMB6,309 million or 15.9% from RMB39,598 million in 2005 to RMB45,907 million in 2006. As a result of improved passenger load factor and average yield, operating profit was RMB312 million in 2006 as compared to an operating loss of RMB1,305 million in 2005. The Group's net non-operating income was RMB45 million as compared to a net non operating expenses of RMB548 million in 2005. The improvement in non operating result was mainly attributable to the net effect of increase in exchange gain of RMB272 million, increase in interest expense of RMB454 million, increase in share of results of associates and jointly controlled entities of RMB369 million and increase in gain on disposal of property, plant and equipment of RMB367 million.



OPERATING REVENUE

Substantially all of the Group's operating revenue is attributable to airline and airline related operations. Traffic revenue accounted for 97.6% and 97.7% of total operating revenue in 2006 and 2005 respectively. Passenger revenue and cargo and mail revenue accounted for 92.2% and 7.8% respectively of total traffic revenue in 2006. The other operating revenue is mainly derived from commission income, income from general aviation operations, fees charged for ground services rendered to other Chinese airlines and air catering services.

The increase in operating revenue was primarily due to a 21.0% rise in passenger revenue from RMB34,328 million in 2005 to RMB41,549 million in 2006 resulting from increased traffic volume. The total number of passengers carried increased by 11.5% to 49.21 million passengers in 2006. RPKs increased by 12.4% from RMB61,923 million in 2005 to RMB69,582 million in 2006, primarily as a result of the increase in passengers carried. Passenger yield increased by RMB0.05.

Domestic passenger revenue, which accounted for 82.2% of the total passenger revenue in 2006, increased by 21.3% from RMB28,182 million in 2005 to RMB34,174 million in 2006. Domestic passenger traffic in RPKs increased by 12.9%, mainly due to an increase in number of passengers carried. Domestic passenger yield increased from RMB0.55 to RMB0.60 in 2006.

Management Discussion and Analysis (Cont'd)

OPERATING REVENUE (Cont'd)

Hong Kong and Macau passenger revenue, which accounted for 3.0% of total passenger revenue, increased by 3.0% from RMB1,194 million in 2005 to RMB1,230 million in 2006. For Hong Kong and Macau flights, passenger traffic in RPKs decreased slightly by 0.5%, while passenger capacity in ASKs decreased by 7.4%, resulting in a 4.4 percentage point increase in passenger load factor from 2005. Passenger yield increased from RMB0.77 in 2005 to RMB0.80 in 2006 mainly due to higher ticket price for compensating surging fuel cost.

International passenger revenue, which accounted for 14.8% of total passenger revenue, increased by 24.1% from RMB4,952 million in 2005 to RMB6,145 million in 2006. For international flights, passenger traffic in RPKs increased by 11.4%, while passenger capacity in ASKs increased by 9.0%, resulting in a 1.4 percentage point rise in passenger load factor from 2005. Passenger yield increased by 10.7% from RMB0.56 in 2005 to RMB0.62 in 2006 mainly resulted from the continued growth of demand for international flights in the PRC.

Cargo and mail revenue, which accounted for 7.8% of the Group's total traffic revenue and 7.7% of total operating revenue, increased by 14.5% from RMB3,091 million in 2005 to RMB3,538 million in 2006. The increase was attributable to the increasing traffic demand.

Other operating revenue increased by 29.5% from RMB874 million in 2005 to RMB1,132 million in 2006. The increase was primarily due to the general growth in income from various auxiliary operations.

OPERATING EXPENSES

Total operating expenses in 2006 amounted to RMB45,907 million, representing an increase of 15.9% or RMB6,309 million over 2005, primarily due to the total effect of increases in jet fuel costs, and aircraft and traffic servicing expenses. Total operating expenses as a percentage of total operating revenue decreased from 103.4% in 2005 to 99.3% in 2006.

Flight operations expenses, which accounted for 53.7% of total operating expenses, increased by 27.2% from RMB19,394 million in 2005 to RMB24,667 million in 2006, primarily as a result of increases in jet fuel costs, operating lease payments, catering expenses and labour costs for flight personnel. Jet fuel costs, which accounted for 65.6% of flight operations expenses, increased by 35.7% from RMB11,929 million in 2005 to RMB16,193 million in 2006 mainly as a result of increased fuel prices and fuel consumption. Operating lease payments increased by 21.2% from RMB2,497 million in 2005 to RMB3,027 million in 2006 primarily due to the additional rental payments for new aircraft under operating leases. Catering expenses increased by 4.0% from RMB1,196 million in 2005 to RMB1,244 million in 2006 due to the increase in number of passengers carried. Labour costs for flight personnel increased by 5.9% from RMB1,619 million in 2005 to RMB1,714 million in 2006, largely due to the increase in flying hours. CAAC Infrastructure Development Fund Contributions increased by 15.2% from RMB978 million in 2005 to RMB1,127 million in 2006.



Management Discussion and Analysis (Cont'd)

OPERATING EXPENSES (Cont'd)

Maintenance expenses which accounted for 8.7% of total operating expenses, decreased by 12.9% from RMB4,589 million in 2005 to RMB3,999 million in 2006. The decrease was mainly due to certain major overhaul costs capitalised during the year.

Aircraft and traffic servicing expenses, which accounted for 13.5% of total operating expenses, increased by 8.0% from RMB5,759 million in 2005 to RMB6,219 million in 2006. The increase primarily resulted from a 6.7% rise in landing and navigation fees from RMB4,891 million in 2005 to RMB5,220 million in 2006, due to an increase in number of landing and takeoffs.



Promotional and sales expenses, which accounted for 6.1% of total operating expenses, increased slightly by 1.1% from RMB2,780 million in 2005 to RMB2,811 million in 2006.

General and administrative expenses, which accounted for 6.8% of the total operating expenses, increased by 27.8% from RMB2,457 million in 2005 to RMB3,140 million in 2006. This was mainly attributable to increased scale of operations and retirement benefits in 2006.

Depreciation and amortisation, which accounted for 10.8% of total operating expenses, increased by 12.0% from RMB4,440 million in 2005 to RMB4,971 million in 2006, mainly resulting from the additional depreciation charge on aircraft delivered in 2005 and 2006 and depreciation charge on capitalised major overhaul costs.

OPERATING PROFIT/(LOSS)

There is an operating profit of RMB312 million in 2006 as compared to an operating loss of RMB1,305 million in 2005. This was mainly because operating revenue increased by RMB7,926 million or 20.7% in 2006 while operating expenses increased by RMB6,309 million or 15.9% in the same period.

NON-OPERATING INCOME/(EXPENSES)

Interest expense increased by 28.1% from RMB1,616 million in 2005 to RMB2,070 million in 2006, mainly due to the increase in loans and interest rate. Interest income decreased by 25.5% from RMB55 million in 2005 to RMB41 million in 2006, mainly attributable to the decrease in average bank balances during 2006.

Net exchange gain increased by 22.3% from RMB1,220 million in 2005 to RMB1,492 million in 2006, mainly resulted from Renminbi appreciation during 2006. Such amount mainly represents unrealised translation gain on retranslation of foreign currency denominated liabilities at year end.

Net gain on disposal of property, plant and equipment was RMB335 million in 2006 as compared to a net loss on disposal of property, plant and equipment of RMB32 million in 2005. The gain in 2006 was mainly the result of disposal of three Boeing 757-200 aircraft to independent third parties.

Management Discussion and Analysis (Cont'd)

TAXATION

The statutory income tax rate in the PRC is 33%. The Company and its branches are taxed at rates ranging from 15% to 33%. The subsidiaries of the Group are taxed at rates ranging from 15% to 33%.

Income tax expense for the year increased to RMB153 million as compared to an income tax benefit of RMB7 million in 2005. This is mainly attributable to the improved financial performance of the Group.

LIQUIDITY, FINANCIAL RESOURCES AND CAPITAL STRUCTURE

As at 31 December 2006, the Group's net current liabilities exceeded its current assets by RMB32,180 million (2005: RMB25,907 million). For the year ended 31 December 2006, the Group recorded a net cash inflow from operating activities of RMB2,295 million, a net cash outflow from investing activities of RMB5,482 million and a net cash inflow from financing activities of RMB2,550 million and a decrease in cash and cash equivalents of RMB637 million (2005: a decrease of RMB182 million).

In 2007 and thereafter, the liquidity of the Group is primarily dependent on its ability to maintain adequate cash inflow from operations to meet its debt obligations as they fall due, and on its ability to obtain adequate external finance to meet its committed future capital expenditures. The Group has obtained firm commitments from its principal bankers to renew its short-term bank loans outstanding at 31 December 2006 when they fall due during 2007. Up to the date of the annual report, the Group was granted banking facilities by several PRC commercial banks for providing loan finance up to approximately RMB59,978,000,000 in 2007. The directors of the Company believe that sufficient financing will be available to the Group.

The directors of the Company have carried out a detailed review of the cash flow forecast of the Group for the twelve months ending 31 December 2007. Based on such forecast, the directors have determined that adequate liquidity exists to finance the working capital and capital expenditure requirements of the Group during that period.

As at 31 December 2006, the Group's borrowings totalled RMB49,238 million, representing an increase of RMB4,443 million from RMB44,795 million at 31 December 2005 which included borrowings of fixed interest rates amounted to RMB17,261 million (2005: RMB18,246 million). Such borrowings were denominated, to a larger extent, in United States dollars and, to a smaller extent, in Japanese yen, Hong Kong dollars and Renminbi. Of such borrowings, RMB26,913 million, RMB5,786 million, RMB4,886 million, RMB3,257 million and RMB8,396 million will be repayable in 2007, 2008, 2009, 2010, 2011 and thereafter respectively. As at 31 December 2006, cash and cash equivalents of the Group totalling RMB2,264 million, of which 15.0% were denominated in foreign currencies, decreased by 22.0% from RMB2,901 million at 31 December 2005.



Management Discussion and Analysis (Cont'd)

LIQUIDITY, FINANCIAL RESOURCES AND CAPITAL STRUCTURE (Cont'd)

Net debts (total borrowings net of cash and cash equivalents) increased by 12.1% to RMB46,974 million at 31 December 2006.

As at 31 December 2006, total equity attributable to equity shareholders of the Company amounted to RMB10,188 million, representing an increase of RMB188 million from RMB10,000 million at 31 December 2005. Total equity at 31 December 2006 amounted to RMB12,121 million (2005: RMB RMB11,936 million).

Ratio of net debt to total equity of the Group at 31 December 2006 was 3.9 times, as compared to 3.5 times at 31 December 2005.

FINANCIAL RISK MANAGEMENT POLICY

Foreign currency risk

The Renminbi is not freely convertible into foreign currencies. All foreign exchange transactions involving Renminbi must take place either through the People's Bank of China ("PBOC") or other institutions authorised to buy and sell foreign exchange or at a swap centre.

The Group has significant exposure to foreign currency as substantially all of the Group's lease obligations and bank loans are denominated in foreign currencies, principally US dollars, and to a lesser extent, Japanese Yen and Hong Kong dollars. Depreciation or appreciation of the Renminbi against foreign currencies affects the Group's results significantly because the Group's foreign currency payments generally exceed its foreign currency receipts. The Group is not able to hedge its foreign currency exposure effectively other than by retaining its foreign currency denominated earnings and receipts to the extent permitted by the State Administration of Foreign Exchange, or subject to certain restrictive conditions, entering into forward foreign exchange contracts with authorised PRC banks.

The exchange rate of Renminbi to US dollar was set by the PBOC and had fluctuated within a narrow band prior to 21 July 2005. Since then, a managed floating exchange rate regime based on market supply and demand with reference to a basket of foreign currencies has been used and US dollar exchange rate has gradually declined against the Renminbi.

Jet fuel price risk

The Group allows for the judicious use of approved derivative instruments such as swaps and options with approved counter-parties and within approved limits to manage the risk of surge of jet fuel price. In addition, counter-party credit risk is generally restricted to any gains on changes in fair value at any time, and not the principal amount of the instrument. Therefore, the possibility of material loss arising in the event of non-performance by counter-party is considered to be unlikely.

CHARGE ON ASSETS

As at 31 December 2006, certain aircraft of the Group with an aggregate carrying value of approximately RMB30,075 million (2005: RMB30,408 million) were mortgaged under certain loan and lease agreements.

Management Discussion and Analysis (Cont'd)

COMMITMENTS AND CONTINGENCIES

Commitments

As at 31 December 2006, the Group had capital commitments of approximately RMB68,705 million. Of such amounts, RMB66,881 million related to the acquisition of aircraft and related flight equipment and RMB1,824 million for other projects.

As at 31 December 2006, the Group was committed to make capital contributions to a jointly controlled entity amounted to approximately RMB83 million.

Contingent Liabilities

The Group leases from CSAHC certain land in Guangzhou and certain land and buildings in Wuhan, Haikou and Zhengzhou. The Group has a significant investment in buildings and other leasehold improvements located on such land. However, such land in Guangzhou and such land and buildings in Wuhan, Haikou and Zhengzhou lack adequate documentation evidencing CSAHC's rights thereto.

The Group cannot predict the magnitude of the effect on its financial condition or results of operations to the extent that their uses of one or more of the above parcels of land or the related facilities were successfully challenged. Pursuant to an indemnification agreement dated 22 May 1997 entered into between CSAHC and the Company, CSAHC has agreed to indemnify the Group against any loss or damage caused by any challenge or interference with the Group's use of any of its land and buildings.