CHINA EASTERN AIRLINES CORP LTD
Form 20-F
June 28, 2007

As filed with Securities and Exchange Commission on June 28, 2007

SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 20-F

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

OR

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

For the fiscal year ended December 31, 2006

OR

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

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

Commission file number 1-14550

(Exact Name of Registrant as Specified in Its Charter)

China Eastern Airlines Corporation Limited	The People's Republic of China
(Translation of Registrant's Name Into English)	(Jurisdiction of Incorporation or Organization)

2550 Hongqiao Road
Hongqiao Airport
Shanghai 200335
The People's Republic of China
(8621) 6268-6268
(Address and Telephone Number of Principal Executive Offices)

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

Title of Each Class	Name of Each Exchange on Which Registered
American Depositary Shares	The New York Stock Exchange
Ordinary H Shares, par value RMB1.00 per share	The New York Stock Exchange*

* Not for trading, but only in connection with the registration of American Depositary Shares. The Ordinary H Shares are also listed and traded on The Stock Exchange of Hong Kong Limited.

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

None
(Title of Class)

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

None
(Title of Class)

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report.

As of December 31, 2006, 3,300,000,000 Ordinary Domestic Shares, par value RMB1.00 per share, were issued and outstanding, and 1,566,950,000 Ordinary H Shares par value RMB1.00 per share, were issued and outstanding. H Shares are Ordinary Shares of the Company listed on The Stock Exchange of Hong Kong Limited.

Indicate by check mark if the registrant is a well-known seasoned issuers, as defined in Rule 405 of the Securities Act. Yes o No þ

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. Yes o No þ

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

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

Large Accelerated Filer o   Accelerated Filer þ   Non-Accelerated Filer o

Indicate by check mark which financial statement item the registrant has elected to follow. Item 17 o Item 18 þ

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

China Eastern Airlines Corporation Limited

SUPPLEMENTAL INFORMATION AND EXCHANGE RATES
CAUTIONARY STATEMENT WITH RESPECT TO FORWARD-LOOKING STATEMENTS
GLOSSARY OF TECHNICAL TERMS

SUPPLEMENTAL INFORMATION AND EXCHANGE RATES

In this Annual Report, unless otherwise specified, the term "dollars", "U.S. dollars" or "US$" refers to United States dollars, the legal tender currency of the United States of America, or the United States or the U.S.; the term "Renminbi" or "RMB" refers to Renminbi, the legal tender currency of The People's Republic of China, or China or the PRC; and the term "Hong Kong dollars" or "HK$" refers to Hong Kong dollars, the legal tender currency of the Hong Kong Special Administrative Region of China, or Hong Kong.

In this Annual Report, the term "we", "us", "our", "our Company" or "China Eastern" refers to China Eastern Airlir Corporation Limited, a joint stock limited company incorporated under the laws of the PRC on April 14, 1995, and, unless the context otherwise requires, its subsidiaries, or, in respect of references to any time prior to the incorporation of China Eastern Airlines Corporation Limited, the core airline business carried on by its predecessor, China Eastern Airlines, which was assumed by China Eastern Airlines Corporation Limited pursuant to the restructuring described in this Annual Report. The term "CEA Holding" refers to our parent, China Eastern Air Holding Company, which was established on October 11, 2002 as a result of the merger of our former controlling shareholder, Eastern Air Group Company, or EA Group, with China Northwest Airlines Company and Yunnan Airlines Company.

For the purpose of this Annual Report, references to The People's Republic of China, China and the PRC do not include Hong Kong, the Macau Special Administrative Region of China, or Macau, or Taiwan.

CAUTIONARY STATEMENT WITH RESPECT TO FORWARD-LOOKING STATEMENTS

Certain information contained in this Annual Report may be deemed to constitute forward-looking statements. These forward-looking statements include, without limitation, statements relating to:

- our fleet development plans, including, without limitation, related financing, schedule, intended use and planned disposition;
- the planned expansion of our cargo operations;
- the impact of changes in the policies of the General Administration of Civil Aviation of China (formerly the Civil Aviation Administration of China), or the CAAC, regarding route rights;
- the impact of the CAAC policies regarding the restructuring of the airline industry in China;
- certain statements with respect to trends in prices, volumes, operations, margins, risk management, overall market trends and exchange rates;
- our expansion plans, including acquisition of other airlines;
- our marketing plans, including the establishment of additional sales offices;
- our plan to add new pilots; and
- the impact of unusual events on our business and operations.

The words or phrases "aim", "anticipate", "believe", "continue", "could", "estimate", "expect", "going forward", "intend", "o "plan", "potential", "predict", "project", "seek", "should", "will", "would", and similar expressions, as they relate to our Comp management, are intended to identify "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities and Exchange Act of 1934, as amended, or the Exchange

Act. These forward-looking statements are based on current plans and estimates, and speak only as of the date they are made. We undertake no obligation to update or revise any forward-looking statement in light of new information, future events or otherwise. Forward-looking statements are, by their nature, subject to inherent risks and uncertainties, some of which are beyond our control, and are based on assumptions and analyses made by us in light of our experience and our perception of historical trends, current conditions and expected future developments, as well as other factors we believe are appropriate in particular circumstances. We caution you that a number of important factors could cause actual outcomes to differ, or to differ materially, from those expressed in any forward-looking statement, including, without limitation:

- any changes in the regulatory policies of the CAAC;
- the effects of competition on the demand for and price of our services;
- the availability of qualified flight personnel and airport facilities;
- any significant depreciation of Renminbi or Hong Kong dollars against U.S. dollars, Japanese yen or Euro, the currencies in which the majority of our borrowings are denominated;
- the availability and cost of aviation fuel;
- changes in political, economic, legal and social conditions in China;
- the fluctuation of interest rates;
- our ability to obtain adequate financing, including any required external debt and acceptable bank guarantees; and
- general economic conditions in markets where our Company operates.

GLOSSARY OF TECHNICAL TERMS

Capacity measurements

ATK (available tonne-kilometers)	the number of tonnes of capacity available for the carriage of revenue load (passengers and cargo) multiplied by the distance flown
ASK (available seat kilometers)	the number of seats made available for sale multiplied by the distance flown
AFTK (available freight tonne-kilometers)	the number of tonnes of capacity available for the carriage of cargo and mail multiplied by the distance flown

Traffic measurements

revenue passenger-kilometers or RPK	the number of passengers carried multiplied by the distance flown
revenue freight tonne-kilometers or RFTK	cargo and mail load in tonnes multiplied by the distance flown
revenue passenger tonne-kilometers or RPTK	passenger load in tonnes multiplied by the distance flown
revenue tonne-kilometers or RTK	load (passenger and cargo) in tonnes multiplied by the distance flown

Load factors

overall load factor	tonne-kilometers expressed as a percentage of ATK
passenger load factor	passenger-kilometers expressed as a percentage of ASK
break-even load factor	the load factor required to equate traffic revenue with our operating costs assuming that our total operating surplus is attributable to scheduled traffic operations

Yield and cost measurements

passenger yield (revenue per passenger-kilometer)	revenue from passenger operations divided by passenger-kilometers
cargo yield (revenue per cargo tonne-kilometer)	revenue from cargo operations divided by cargo tonne-kilometers

average yield (revenue per total tonne-kilometer)	revenue from airline operations divided by tonne-kilometers
unit cost	operating expenses divided by ATK
tonne	a metric ton, equivalent to 2,204.6 lbs

PART I

Item 1. Identity of Directors, Senior Management and Advisers

Not applicable.

Item 2. Offer Statistics and Expected Timetable

Not applicable.

Item 3. Key Information

A. Selected Financial Data

The selected financial data from the consolidated income statements for the years ended December 31, 2002, 2003, 2004, 2005 and 2006 and the selected financial data from the balance sheets as of December 31, 2002, 2003, 2004, 2005 and 2006 have been derived from our audited consolidated financial statements, which have been prepared in accordance with International Financial Reporting Standards, or IFRS, and audited by PricewaterhouseCoopers, an independent registered public accounting firm in Hong Kong. PricewaterhouseCoopers' reports in respect of the consolidated income statements for the years ended December 31, 2004, 2005 and 2006 and the consolidated balance sheets as of December 31, 2005 and 2006 and the related footnotes are included in this Annual Report. PricewaterhouseCoopers' reports in respect of the consolidated income statements for the years ended December 31, 2002 and 2003 and the consolidated balance sheets as of December 31, 2002, 2003 and 2004 and the related footnotes are not included in this Annual Report.

As required under IFRS, the acquisition accounting method was applied to account for our acquisitions of certain selected assets and liabilities relating to the aviation businesses of CEA Yunnan (as defined below) and CEA Northwest (as defined below) in 2005, as described in "Item 4. Information on the Company — The History and Development of the Company", such that, as of June 30, 2005, only the acquired assets and liabilities, which did not include certain legal liabilities, were included in the consolidated financial statements. The results of the acquired operations and their related cash flows were included in the consolidated financial statements of the Company beginning July 1, 2005. In contrast, under generally accepted accounting principles in the United States, or U.S. GAAP, such transactions are considered to be a "combination of entities under common control" since we and the aviation businesses of CEA Yunnan and CEA Northwest were under the common control of CEA Holding. Such transactions were accounted for in a manner similar to "pooling-of-interests", retroactively restating all years presented on a combined basis as if the acquisitions had been in effect since inception, whereby related assets and liabilities of the acquired aviation businesses would be accounted for at historical cost and the related results of operations would be included in the consolidated financial statements from the earliest year presented. For a summary of significant differences between IFRS and U.S. GAAP as they relate to us and the effects of such differences on net profit (loss) attributable to equity holders and net assets for all years presented, see Note 40 to our audited consolidated financial statements included in this Annual Report. Our condensed consolidated financial statements prepared and presented in accordance with U.S. GAAP to reflect the effect of the acquisitions of certain selected assets and liabilities relating to the aviation businesses of CEA Yunnan and CEA Northwest under common control for the relevant periods are set forth in Note 41 to our audited consolidated financial statements included in this Annual Report.

The following information should be read in conjunction with, and is qualified in its entirety by our audited consolidated financial statements included in this Annual Report.

	Year Ended December 31,				
	2002	2003	2004	2005	2006
	RMB	RMB	RMB	RMB	RMB
	(in millions, except per share or per ADS data)				
Consolidated Income Statements Data:					
IFRS:(1)					
Revenues	13,332	14,470	21,386	27,454	37,489
Other operating income	63	50	85	245	424
Operating expenses	(12,350)	(14,454)	(20,239)	(27,685)	(40,905)
Operating profit (loss)	1,045	66	1,232	14	(2,991)
Finance costs, net	(777)	(775)	(641)	(578)	(757)
Profit (loss) before income tax	235	(741)	586	(577)	(3,616)
Profit (loss) for the year attribute to equity holders of the Company	64	(1,097)	321	(467)	(3,313)
Basic and fully diluted earnings (loss) per share	0.01	(0.23)	0.07	(0.10)	(0.68)
Basic and fully diluted earnings (loss) per ADS	1.31	(22.54)	6.59	(9.60)	(68.07)
U.S. GAAP					
Profit (loss) attributable to equity holders	(365)	(1,391)	459	(1,383)	(3,661)
Basic and fully diluted earnings (loss) per share(2)	(0.08)	(0.29)	0.09	(0.28)	(0.75)
Basic and fully diluted earnings (loss) per ADS	(7.51)	(28.59)	9.43	(28.42)	(75.22)

	As of December 31,				
	2002	2003	2004	2005	2006
	RMB	RMB	RMB	RMB	RMB
	(in millions)				
Balance Sheet Data:					
IFRS: (1)					
Cash and cash equivalents	1,945	1,583	2,114	1,864	1,987
Net current liabilities	(7,504)	(9,982)	(12,491)	(25,572)	(24,792)
Non-current assets	28,147	33,039	36,812	52,882	52,152
Long term borrowing, including current portion	(6,495)	(11,223)	(10,736)	(12,659)	(14,932)
Obligations under finance lease, including current portion	(8,184)	(7,101)	(8,662)	(10,588)	(11,853)
Total share capital and reserves	7,319	6,175	6,481	6,096	2,815
U.S. GAAP:					
Total assets	45,462	50,598	53,487	59,218	62,089
Owner’s equity	5,934	4,543	5,028	6,100	1,896

(1)

Certain income and expenses and balance sheet data for the years ended December 31, 2002, 2003, 2004 and 2005 have been reclassified under IFRS. Such reclassifications have no effect on the profit (loss) attributable to equity holders and net assets for each of those affected years.

(2) The calculation of earnings (loss) per share is based on the consolidated profit (loss) attributable to equity holders and 4,866,950,000 shares in issue.

Selected Operating Data

The following table sets forth certain operating data of our Company for the five years ended December 31, 2006, which have been derived from financial information prepared in accordance with IFRS and other data provided by us and are not audited. All references in this Annual Report to our cargo operations, cargo statistics or cargo revenues include figures for cargo and mail.

	Year Ended December 31,				
	2002	**2003**	**2004**	**2005**	**2006**
Selected Airline Operating Data:					
Capacity:					
ATK (millions)	4,366.6	4,774.5	7,071.2	8,751.5	11,065.6
ASK (millions)	27,962.5	29,780.0	41,599.1	52,427.9	70,468.3
AFTK (millions)	1,850.0	2,094.3	3,327.3	4,033.0	4,723.4
Traffic:					
Revenue passenger-kilometers (millions)	18,206.4	18,002.7	27,580.8	36,380.6	50,271.9
Revenue tonne-kilometers (millions)	2,652.2	2,907.7	4,340.7	5,395.2	6,931.0
Revenue passenger tonne-kilometers (millions)	1,629.2	1,611.1	2,466.0	3,243.7	4,487.0
Revenue freight tonne-kilometers (millions)	1,023.0	1,296.6	1,874.7	2,151.5	2,444.0
Kilometers flown (millions)	158.8	176.5	242.8	287.7	434.6
Hours flown (thousands)	234.6	259.4	360.4	467.8	678.3
Number of passengers carried (thousands)	11,533.1	12,040.2	17,711.0	24,290.5	35,039.7
Weight of cargo carried (millions of kilograms)	344.7	459.8	663.6	775.5	893.2

	Year Ended December 31,				
	2002	**2003**	**2004**	**2005**	**2006**
Average distance flown (kilometers per passenger)	1,578.6	1,495.2	1,557.3	1,497.7	1,434.7
Load Factor:					
Overall load factor (%)	60.7	60.9	61.4	61.7	62.6
Passenger load factor (%)	65.1	60.5	66.3	69.4	71.3
Break-even load factor (based on ATK) (%)	59.9	63.6	62.2	66.0	71.1
Yield and Cost Statistics (RMB):					
Passenger yield (passenger revenue/ passenger-kilometers)	0.55	0.57	0.56	0.57	0.61
Cargo yield (cargo revenue/cargo tonne-kilometers)	2.39	2.46	2.36	2.31	2.30
Average yield (passenger and cargo revenue/ tonne-kilometers)	4.71	4.62	4.60	4.79	5.20
Unit cost (operating expenses/ATK)	2.87	2.94	2.86	3.16	3.70

B. Capitalization and Indebtedness

Not applicable.

C. Reasons for the Offer and Use of Proceeds

Not applicable.

D. Risk Factors

An investment in our Company involves a number of risks, some of which may be special or significantly different from risks that are normally associated with an investment in a U.S. company. You should carefully consider the following information about the risks in investing in our Company, along with the other information presented in this Annual Report.

Fuel supply and costs

The availability and cost of aviation fuel has a significant impact on our financial condition and results of operations. In the past, jet fuel shortages have occurred in China and, on limited occasions, required us to delay or cancel flights. Although jet fuel shortages have not occurred since the end of 1993, we cannot assure you that jet fuel shortages will not occur in the future. Fuel prices continue to be susceptible to, among other factors, political unrest in various parts of the world, Organization of Petroleum Exporting Countries policy, the rapid growth of the economies in China and India, the levels of inventory carried by industries, the amounts of reserves built by governments, disruptions to production and refining facilities and weather conditions. These and other factors that impact the global supply and demand for aircraft fuel may affect our financial performance due to its sensitivity to fuel prices. Our financial performance may be especially susceptible to recent trends of escalating fuel prices worldwide.

Fuel costs constitute a significant portion of our operating costs and, in 2006, accounted for approximately 33.3% of our operating expenses. Between 2005 and 2006, our expenses for fuel rose by 53.1%, partially as a result of increased weighted average domestic and international fuel prices, and partially as a result of the expansion of our fleet. Between 2005 and 2006, the weighted average fuel prices that we paid increased by approximately 33.6%. Due to the highly competitive nature of the airline industry and government regulation on airfare pricing, we may be unable to fully or effectively pass on to our customers any increased fuel costs we may encounter in the future. Any jet fuel shortages or any increase in domestic or international jet fuel prices may materially and adversely affect our financial condition and results of operations. From time to time, we may hedge some of our future fuel purchases to protect against potential spikes in price. However, these hedging strategies may not always be effective and can result in losses depending on price changes.

Competition

We face intense competition in each of the domestic, Hong Kong regional and international markets that we serve. In our domestic markets, we compete against smaller domestic airline companies that operate with costs that are lower than ours. We also face increasing competition from entrants to our domestic markets, as new investments into China's civil aviation industry are made following the CAAC's relaxation of certain private-sector investment rules in July 2005. See the section headed "Item 4. Information on the Company — Business Overview — Competition" for more details. In our Hong Kong regional and international markets, we compete against international airline companies that have significantly longer operating histories, greater name recognition, more resources or larger sales networks than we do, or utilize more developed reservation systems than ours. The public's perception of the safety records of Chinese airlines also materially and adversely affects our ability to compete against our international competitors. In response to competition, we have, from time to time in the past, lowered our airfares for certain of our routes, and we may be required to do the same in the future. Increased competition and pricing pressures from competition may have a material adverse effect on our financial condition and results of operations.

Government regulation

The Chinese civil aviation industry is subject to a high degree of regulation by the CAAC. Regulatory policies issued or implemented by the CAAC encompass virtually every aspect of airline operations, including, among other things:

- route allocation;
- pricing of domestic airfares;
- the administration of air traffic control systems and certain airports; and
- aircraft registration and aircraft airworthiness certification.

As a result, we may face significant constraints on our flexibility and ability to expand our business operations or to maximize our profitability.

Government ownership and control of our Company

Most of the major airline companies in China are currently majority-owned either by the central government of China or by provincial or municipal governments in China. CEA Holding currently holds approximately 61.64% of our Company's equity interests on behalf of the PRC Government. As a result, CEA Holding will be able to elect our entire Board of Directors and otherwise be able to control us. CEA Holding will also have sufficient voting control to effect transactions without the concurrence of our minority shareholders. The interests of the PRC Government as the ultimate controlling person of our Company and most of other major Chinese airlines could conflict with the interests of our minority shareholders. Although the CAAC currently has a policy of equal treatment for all Chinese airlines, we cannot assure you that the CAAC will not favor other Chinese airlines over our Company.

Insurance coverage and cost

As a result of the events of September 11, 2001, aviation insurers have significantly reduced the maximum amount of insurance coverage available to commercial air carriers for liability to persons other than employees or passengers for claims resulting from acts of terrorism, war or similar events, or war-risk coverage. At the same time, they have significantly increased the premiums for such coverage, as well as for aviation insurance in general. Also, our Company further extended our insurance coverage purchased prior to the September 11 events to November 30, 2006, and renewed such coverage on December 1, 2006 for one year. However, if the insurance carriers reduce further the amount of insurance coverage available or increase the premium for such coverage when we renew our insurance coverage, our financial condition and results of operations may be materially and adversely affected.

Direct air link between China's mainland and Taiwan

Currently, our operations on the Hong Kong regional routes benefit from traffic between Hong Kong and mainland China ultimately originating in Taiwan. During the Lunar Chinese New Year peak travel season in 2003, from late-January to mid-February, the PRC Government allowed special chartered flights between Shanghai and Taiwan for the first time. During the Lunar Chinese New Year peak travel seasons from late-January to mid-February in 2006 and 2007, respectively, airlines from both mainland China and Taiwan (including our Company) operated 72 and 96 non-stop direct chartered flights between selected cities in mainland China and Taiwan. In 2006, the PRC Government allowed for the first time direct flights during the Mid-Autumn Festival holiday from late-September to early-October. During this holiday, airlines from both mainland China and Taiwan (including our Company) operated approximately 22 non-stop direct chartered flights on passenger traffic routes that included Beijing-Taipei, Shanghai-Taipei, Guangzhou-Taipei, Xiamen-Gaoxiong (Kaohsiung), and Xiamen-Taipei. In addition, direct flights were permitted for the first time during the observance of Qingming (Ching Ming) Festival from late-March to early-April in 2007. During this period, 11 airlines from both mainland China and Taiwan (including our Company) operated a total of 42 direct flights on the same passenger traffic routes. Although regular direct flights between Taiwan and mainland China are still not permitted, our Hong Kong regional routes may be materially and adversely affected if such regular direct flights are permitted in the future. We cannot assure you that we will obtain sufficient Taiwan-mainland China routes, or that the yields on these routes will be adequate, to offset any material adverse effect on our revenues derived from our Hong Kong regional routes.

Chinese aviation infrastructure limitations and safety

The rapid increase in air traffic volume in China in recent years has put pressure on many components of the Chinese airline industry, including air traffic control systems, the availability of qualified flight personnel and airport facilities. Our ability to provide safe air transportation depends on the availability of qualified and experienced pilots in China and the improvement of maintenance services, national air traffic control and navigational systems and ground control operations at Chinese airports. If any of these is not available or is inadequate, our ability to provide safe air transportation will be compromised and our financial condition and results of operations may be materially and adversely affected.

Operating leverage

The airline industry is characterized by a high degree of operating leverage. Due to high fixed costs, including payments made in connection with aircraft leases, the expenses relating to the operation of any given flight do not vary proportionately with the number of passengers carried, while revenues generated from a particular flight are directly related to the number of passengers carried and the fare structure of the flight. Accordingly, a decrease in revenues may result in a proportionately higher decrease in profits.

Liquidity

We have substantial debts, and will continue to have substantial debts in the future. In addition, we entered into contractual commitments in June 2006 to acquire a number of new aircraft for delivery over the next few years. See the section headed "Item 4. Information on the Company — Property, Plants and Equipment — Fleet". As of December 31, 2006, our total outstanding debt was RMB57,689 million, and our long-term debt to equity ratio was 7.7. As of the same date, our current liabilities exceeded our current assets by RMB24,792 million. Short-term bank loans outstanding totaled RMB13,176 million as of December 31, 2006.

We are largely dependent upon cash flows generated from our operations and external financing (including short-term bank loans) to meet our debt repayment obligations and working capital requirements. If our operating cash flow is materially and adversely affected by factors such as increased competition, a significant decrease in demand for our services, or a significant increase in jet fuel prices, our liquidity would be materially and adversely affected. We have arranged financing with domestic and foreign-funded banks in China as necessary to meet our working capital requirements. We have also tried to ensure our liquidity by structuring a substantial portion of our short-term bank loans to be rolled over upon maturity. These efforts, however, may ultimately prove insufficient. Our ability to obtain financing may be affected by our financial position and leverage and our credit rating, as well as by prevailing economic conditions and the cost of financing in general. If we are unable to obtain adequate financing for our capital requirements, our liquidity and operations would be materially and adversely affected.

Future financing requirements

We require significant amounts of external financing to meet our capital commitments for adding and upgrading aircraft and flight equipment and for other business expansion needs. We generally acquire aircraft through either long-term capital leases or operating leases. In the past, we have obtained, sometimes with the assistance of the CAAC, guarantees from Bank of China and other Chinese banks in respect of payments under our foreign loan and capital lease obligations. However, we cannot assure you that we will be able to continue to obtain bank guarantees in the future. The unavailability of guarantees from Bank of China or other acceptable banks or the increased cost of such guarantees may materially and adversely affect our ability to borrow internationally or enter into international aircraft lease financings on acceptable terms. The ability of our Company to obtain financing may also be affected by our financial position and leverage and our credit rating as well as by prevailing economic conditions and the cost of financing generally. If we were unable to obtain financing for a significant portion of our capital requirements, our ability to acquire new aircraft or expand our operations may be impaired. We have and in the future will likely continue to have substantial debts. As a result, the interest cost associated with these debts might impair our future profitability and cause our earnings to be subject to a higher degree of volatility.

Related party transactions; conflict of interests

We have engaged in, from time to time, and may continue to engage in, in the future, a variety of transactions with CEA Holding and its various members, from whom we receive a number of important services, including support for in-flight catering and assistance with importation of aircraft, flight equipment and spare parts. Our transactions with CEA Holding and its members are conducted through a series of arm's length contracts, which we have entered into with CEA Holding and its members in the ordinary course of business. However, because we are controlled by CEA Holding and CEA Holding may have interests that are different from our interests, we cannot assure you that CEA Holding will not take actions that will serve its interests or the interests of its members over our interests.

Acquisitions

We may expand our business through acquisitions of airline companies or airline-related businesses, such as our acquisition of an equity interest in CEA Wuhan and the acquisition of certain selected assets and liabilities relating to the aviation businesses of CEA Yunnan and CEA Northwest. See “Item 4. Information on the Company” for details. Such acquisitions involve uncertainties and risks, including the following:

· difficulty with integrating the assets and operations of the acquired airline companies or airline-related businesses, including their employees, corporate cultures, managerial systems, processes and procedures and management information systems and services;

· failure to achieve the anticipated synergies, cost savings or revenue-enhancing opportunities resulting from the acquisition of such airline companies or airline-related businesses;

· difficulty with exercising control and supervision over the newly acquired operations; and

· increased financial pressure resulting from the assumption of recorded and unrecorded liabilities of the acquired airline companies or airline-related businesses.

If we are unable to manage or integrate the newly acquired airlines or airline-related businesses successfully without substantial expense, delay or other operational or financial problems, we may be unable to achieve the objectives or anticipated synergies of such acquisitions and such acquisitions may adversely impact the operations and financial results of our existing businesses.

Limitation on foreign ownership

The current CAAC policies limit foreign ownership in Chinese airlines. Under these limits, non-Chinese residents and Hong Kong, Macau or Taiwan residents cannot hold a majority equity interest in a Chinese airline company. At present, approximately 32.2% of our total outstanding shares are held by non-Chinese residents and Hong Kong, Macau or Taiwan residents (excluding the qualified foreign institutional investors that are approved to invest in the A Share market of the PRC). As a result, our access to international equity capital markets may be limited. This restriction may also limit the opportunities available to our Company to obtain funding or other benefits through the creation of equity-based strategic alliances with foreign carriers. We cannot assure you that the CAAC will increase these limits in the near future or at all.

Adverse public health epidemics or pandemics

Adverse public health epidemics or pandemics could disrupt businesses and the national economy of China and other countries where we do business. From December 2002 to June 2003, China and other countries experienced an outbreak of a new and highly contagious form of atypical pneumonia now known as severe acute respiratory syndrome, or SARS. On July 5, 2003, the World Health Organization declared that the SARS outbreak had been contained. However, a number of isolated new cases of SARS were subsequently reported, most recently in central China in April 2004. During May and June of 2003, many businesses in China were closed by the PRC Government to prevent transmission of SARS. Moreover, some Asian countries, including China, have recently encountered incidents of the H5N1 strain of bird flu, or avian flu. We are unable to predict the effect, if any, that avian flu may have on our business. Any future outbreak of SARS, avian flu or similar adverse public health developments may, among other things, severely restrict the level of economic activity in the affected areas, which may in turn significantly reduce demand for our services and have a material adverse effect on our financial condition and results of operations.

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Changes in the economic policies of the PRC Government

Since the late 1970s, the PRC Government has been reforming the Chinese economic system. These reforms have resulted in significant economic growth and social progress. These policies and measures, however, may from time to time be modified or revised. Adverse changes in economic and social conditions in China, in the policies of the PRC Government or in the laws and regulations of China, if any, may have a material adverse effect on the overall economic growth of China and investments in the domestic airline industry. These developments, in turn, may have material adverse effects on our business operations and may also materially and adversely affect our financial condition and results of operations.

Convertibility of Renminbi

A significant portion of our revenue and operating expenses are denominated in Renminbi, while a portion of our revenue, capital expenditures and debts are denominated in U.S. dollars and other foreign currencies. The Renminbi is currently freely convertible under the current account, which includes dividends, trade and service-related foreign currency transactions, but not under the capital account, which includes foreign direct investment, unless the prior approval of the State Administration of Foreign Exchange, or SAFE, is obtained. As a foreign invested enterprise approved by the PRC Ministry of Commerce, or MOFCOM, we can purchase foreign currency without the approval of SAFE for settlement of current account transactions, including payment of dividends, by providing commercial documents evidencing these transactions. We can also retain foreign exchange in our current accounts, subject to a maximum amount approved by SAFE, to satisfy foreign currency liabilities or to pay dividends. However, the relevant PRC Government authorities may limit or eliminate our ability to purchase and retain foreign currencies in the future. Foreign currency transactions under the capital account are still subject to limitations and require approvals from SAFE. This may affect our ability to obtain foreign exchange through debt or equity financing, including by means of loans or capital contributions. We cannot assure you that we will be able to obtain sufficient foreign exchange to pay dividends or satisfy our foreign exchange liabilities.

Fluctuations in exchange rates

The value of the Renminbi against the U.S. dollar and other currencies may fluctuate and is affected by, among other things, changes in the PRC's political and economic conditions. On July 21, 2005, the PRC Government changed its policy of pegging the value of the Renminbi to the U.S. dollar. Under the new policy, the Renminbi is permitted to fluctuate within a narrow and managed band against a basket of certain foreign currencies. This change in policy resulted in an appreciation in the value of the Renminbi against the U.S. dollar of approximately 2.5% in 2005 and 3.4% in 2006. In May 2007, the PRC Government widened the daily trading band of the Renminbi against a basket of certain foreign currencies from 0.3% to 0.5%. It is possible that the PRC Government could adopt a more flexible currency policy, which could result in further and more significant revaluations of the Renminbi against the U.S. dollar or any other foreign currency.

Uncertainties embodied in the PRC legal system

The PRC legal system is a civil law system based on written statutes. Unlike common law systems, it is a system in which decided legal cases have little precedential value. In 1979, the PRC Government began to promulgate a comprehensive system of laws and regulations governing economic matters in general. Legislation over the past 20 years has significantly enhanced the protection afforded to foreign investment in China. However, the interpretation and enforcement of some of these laws, regulations and other legal requirements involve uncertainties that may limit the legal protection available to you.

Legal proceedings

On November 21, 2004, a CRJ-200 Bombadier-supplied aircraft then owned and operated by China Eastern Air Yunnan Company, or CEA Yunnan, crashed shortly after leaving Baotou city in the Inner Mongolia Autonomous Region. All 53 people aboard died in the aircraft accident. In 2005, family members of the deceased sued, among other defendants, our Company in a U.S. court for compensation, the amount of which is yet to be determined. As of December 31, 2006, we had filed a motion to contest the claim in the U.S. court because we expressly did not assume the legal liability of such incident in our acquisition of certain selected assets and liabilities relating to the aviation business of CEA Yunnan. Our Company believes that the U.S. court will render judgment in the near future which will not be unfavorable to our Company in terms of jurisdiction in personam. Should any claims fall outside the scope and/or limit of our insurance coverage, our operations and financial position may be materially and adversely affected. Moreover, any unfavorable outcome could result in substantial harm to our reputation. Although we are not involved in any other litigation, arbitration or claim of material importance, we cannot guarantee you that we will not be engaged in any litigation, arbitration or claim of material importance in the future.

Ineffective internal control over financial reporting as of December 31, 2006

As of the end of the period covered by this report, our management, including our President and Chief Financial Officer, assessed the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the U.S. Securities Exchange Act of 1934, as amended (the “Exchange Act”)). Based on that assessment, our President and Chief Financial Officer concluded that, as of December 31, 2006, our disclosure controls and procedures were not effective due to material weaknesses in our internal control over financial reporting. In its assessment, our management identified the following material weaknesses:

Our Company did not maintain effective controls over the financial reporting process due to an insufficient complement of personnel with a level of accounting knowledge, experience and training in the application of generally accepted accounting principles commensurate with our Company’s financial reporting requirements. This material weakness contributed to the following control deficiencies, each of which is considered to be a material weakness:

(1) Our Company did not maintain effective controls over its process to ensure the completeness and accuracy of the preparation and review of its consolidated financial statements. Specifically, our Company did not have effective controls over the process for identifying, accumulating and reviewing all required supporting information, including the review of certain spreadsheets, to ensure the completeness and accuracy of its consolidated financial statements and disclosures, including the processes required to ensure complete and accurate recording and disclosure relating to deferred income tax accounting, the consolidated statement of cash flows, and certain property, plant and equipment disclosures. This control deficiency resulted in audit adjustments and additional disclosures to the 2006 consolidated financial statements.

(2) Our Company did not maintain effective controls over the completeness and accuracy of our Company’s deferred income tax assets and liabilities and its related provision for income taxes account. Specifically, our Company did not maintain effective controls over the accuracy and completeness of the components of the income tax provision calculations and related deferred income taxes, and over the monitoring of the differences between the income tax basis and the financial reporting basis of assets and liabilities to effectively reconcile the differences to the reported deferred income tax balances. In addition, our Company did not maintain effective controls to ensure that the appropriate factors were used in estimating the valuation allowance for its deferred income tax assets. This control deficiency resulted in audit adjustments to income tax expense and deferred income tax asset and liability accounts in the 2006 annual consolidated financial statements.

While we are implementing steps to restore the effectiveness of our internal control over financial reporting, failure to restore the effectiveness of our internal control over financial reporting could continue to impact our ability to report our financial condition and results of operations accurately and in a timely manner and could have a material adverse effect on our business, results of operations, financial condition and liquidity. See “Item 15. Controls and Procedures” for details.

Agent and employee misconduct

Agent or employee misconduct occurring within the scope of our operations is difficult to detect and deter and could result in violations of law by us, regulatory sanctions, litigation or serious reputational or financial harm. We cannot always deter agent or employee misconduct, and the precautions we take to prevent and detect these activities may not be effective in all cases. In October 2006, two of our Directors were removed from our Company after it was discovered that such Directors were suspected of personal misconduct and are being investigated by governmental authorities. Although this incident has not resulted in material losses, damages, fines or other sanctions against us, we can give no assurance that any agent or employee misconduct in the future will not lead to material losses, damages, fines, administrative actions or criminal proceedings, any of which could materially and adversely affect our business, results of operations or financial condition.

Item 4. Information on the Company

A. History and Development of the Company

Our registered office is located at 66 Airport Street, Pudong International Airport, Shanghai, China, 201202. Our principal executive office is located at 2550 Hongqiao Road, Hongqiao Airport, Shanghai, China, 200335. The telephone number of our principal executive office is (86-21) 6268-6268. We currently do not have an agent for service of process in the United States.

Our Company was established on April 14, 1995 under the laws of China as a company limited by shares in connection with the restructuring of our predecessor and our initial public offering. Our predecessor was one of the six original airlines established in 1988 as part of the decentralization of the airline industry in China undertaken in connection with China’s overall economic reform efforts. Prior to 1988, the CAAC was responsible for all aspects of civil aviation in China, including the regulation and operation of China’s airlines and airports. In connection with our initial public offering, our predecessor was restructured into two separate legal entities, our Company and EA Group. According to the restructuring arrangement, by operation of law, our Company succeeded to substantially all of the assets and liabilities relating to the airline business of our predecessor. EA Group succeeded to our predecessor’s assets and liabilities that do not directly relate to the airline operations and do not compete with our businesses. Assets transferred to EA Group included our predecessor’s equity interests in companies engaged in import and export, real estate, advertising, in-flight catering, tourism and certain other businesses. In connection with the restructuring, we entered into various agreements with EA Group and its subsidiaries for the provision of certain services to our Company. CEA Holding assumed the rights and liabilities of EA Group under these agreements after it was formed by merging EA Group, Yunnan Airlines Company and China Northwest Airlines Company in October 2002. See “Item 7. Major Shareholders and Related Party Transactions” for more details. In 2006, our Company’s total revenue from core operations accounted for approximately 97.3% of CEA Holding’s total revenue. The following chart sets forth the organizational structure of our Company and our significant subsidiaries, all of which were incorporated in China, as of June 22, 2007:

In February 1997, we completed our initial public offering of 1,566,950,000 ordinary H Shares, par value RMB1.00 per share, and listed our ordinary H Shares on The Stock Exchange of Hong Kong Limited, or the Hong Kong Stock Exchange, and American Depositary Shares, or ADSs, representing our H Shares, on the New York Stock Exchange. In October 1997, we completed a public offering of 300,000,000 new ordinary domestic shares in the form of A Shares to public shareholders in China and listed such new shares on the Shanghai Stock Exchange. Following the A Share offering, EA Group continued to own 3,000,000,000 ordinary domestic shares, which represent 90.91% of our total ordinary domestic shares. As of December 31, 2006, EA Group owned 61.64% of our issued and outstanding share capital. H Shares are our ordinary shares listed on the Hong Kong Stock Exchange, and A Shares are our ordinary shares listed on the Shanghai Stock Exchange. Our H Shares and A Shares are identical in respect of all rights and preferences, except that the listed A Shares may only be held by Chinese domestic investors and certain qualified foreign institutional investors. In addition, dividends on the A Shares are payable in Renminbi.

Since our initial public offering, we have expanded our operations through acquisitions and joint ventures. In July 1998, our Company and China Ocean Shipping (Group) Company jointly established China Cargo Airlines Co., Ltd., which specializes in the air freight business. Our total investment in this joint venture was approximately RMB350 million, representing 70% of the equity interest of China Cargo Airlines Co., Ltd. In addition, we purchased from EA Group the assets and liabilities relating to airline operations of China General Aviation Company, for approximately RMB88 million in November 1999. China General Aviation Company was based in Shanxi Province in China and served primarily the northern region of China. Moreover, we completed our acquisition of Air Great Wall in June 2001 and established our Ningbo Branch following the acquisition. Air Great Wall was based in Ningbo, Zhejiang Province in China and served primarily the southeastern region of China.

In May 2002, our Company, jointly with Shanghai Civil Aviation Eastern China Kaiya System Integration Co., Ltd., established Shanghai Eastern Airlines Investment Co., Ltd., or SEAI. We hold a 99% equity interest in SEAI. SEAI serves as one of the investment vehicles of our Company for our investments in other industrial projects and provides consulting services. In August 2002, our Company, jointly with Wuhan Municipal State-owned Assets Management Committee Office and two other independent third parties, established China Eastern Airlines Wuhan Limited, or CEA Wuhan, in which our Company held a 40% equity interest. CEA Wuhan's operating results were consolidated with ours from January 2006, when we obtained control of CEA Wuhan. In March 2006, we completed our acquisition of a 38% equity interest and a 18% equity interest in CEA Wuhan from Wuhan Municipal State-owned Assets Supervision and Administration Committee and Shanghai Junyao Aviation Investment Company Limited, respectively, for an aggregate consideration of approximately RMB418 million. As a result, our equity interest in CEA Wuhan has increased to 96%. CEA Wuhan primarily serves the market in Hubei Province. We also entered into an agreement with Rockwell Collins International Inc. of the United States to establish a joint venture avionics maintenance service company in China in September 2002. Moreover, in November 2002, our Company, jointly with China Aircraft Services Limited, established Shanghai Eastern Aircraft Maintenance Limited, in which our Company holds a 60% equity interest. In order to expand our Company's operations in Jiangsu Province of China, we increased our investment in China Eastern Airlines Jiangsu Co., Ltd., or Eastern Jiangsu, in December 2002, together with other shareholders of Eastern Jiangsu. In 2004, our Company contributed additional capital of approximately RMB408 million to Eastern Jiangsu. As a result, our equity interest in Eastern Jiangsu increased from 55% to 63%.

On March 10, 2003, we entered into a joint venture agreement with Singapore Technologies Aerospace Ltd. to establish Shanghai Technologies Aerospace Company Limited, or STA, a Sino-foreign joint venture limited liability company established under the laws of the PRC. The registered capital of STA is US$73 million with a total investment of US$98 million. Pursuant to the joint venture agreement, our Company shall make an in-kind capital contribution of US$37.23 million (which includes but is not limited to flight equipment and land use rights) in installments to STA. Our Company owns a 51% equity interest in STA. STA is primarily engaged in the provision of commercial aircraft maintenance, repair and overhaul services. STA commenced operations in late 2004.

In April 2003, we entered into a share transfer agreement with CEA Holding, pursuant to which we have acquired from CEA Holding a 45% equity interest in Eastern Aviation Import and Export Company, or EAIEC, for a consideration of approximately RMB44 million. EAIEC was a wholly-owned subsidiary of CEA Holding prior to the transaction. Under the share transfer agreement, our Company and CEA Holding each undertakes to the other party that it will not establish any other entity engaging in any business similar in nature or scope to the business conducted by EAIEC.

In December 2003, we also entered into a joint venture agreement with CEA Holding to establish China Eastern Air Catering Investment Company Ltd., or CEA Catering. The registered capital of CEA Catering is RMB350 million. Pursuant to the joint venture agreement, CEA Holding and our Company made capital contributions of approximately RMB192.5 million and RMB157.5 million, respectively. As a result, CEA Holding and our Company hold a 55% and a 45% equity interest in CEA Catering, respectively. CEA Catering is primarily engaged in the business of providing air and ground catering services, food and beverage supplies and other related services.

In addition, also in December 2003, we entered into an equity transfer and capital increase agreement with CEA Holding and Shanghai Eastern Development Corporation Limited, or SEDC, pursuant to which our Company acquired 10% of SEDC’s then equity interest and 35% of CEA Holding’s then equity interest in Shanghai Dong Mei Aviation Travel Corporation Limited, a company that is primarily engaged in the business of selling air tickets, hotel reservation, travel agency and other related services. After the transaction, our Company holds a 45% equity interest in Shanghai Dong Mei. Our aggregate investment in Shanghai Dong Mei was approximately RMB14.9 million.

On February 18, 2004, we entered into a joint venture agreement with CEA Holding to establish China Eastern Real Estate Investment Co., Ltd., or CEA Real Estate, a limited liability company established under the laws of the PRC. The registered capital of CEA Real Estate is RMB100 million. Pursuant to the joint venture agreement, our Company has made its capital contribution of RMB5 million in cash. As a result, our Company owns a 5% equity interest in CEA Real Estate. CEA Real Estate is primarily engaged in the real estate business, including the development and sales of commercial premises and property leasing in Shanghai, China.

On August 18, 2004, we entered into a joint venture agreement with China Ocean Shipping (Group) Company and China Cargo Airlines Co., Ltd. to establish Shanghai Eastern Logistics Co., Ltd., or Eastern Logistics, a limited liability company established under the laws of the PRC. The registered capital of Eastern Logistics is RMB200 million. Pursuant to the joint venture agreement, our Company has made its capital contribution of RMB138.6 million in cash to Eastern Logistics. Our Company, directly and indirectly, owns a 70% equity interest in Eastern Logistics. Eastern Logistics is primarily engaged in the provision of cargo logistics services. Eastern Logistics commenced operations after it obtained its business license from the relevant government authority on August 23, 2004.

Pursuant to the CAAC's airline industry restructuring plan, EA Group merged with Yunnan Airlines Company and China Northwest Airlines Company and formed CEA Holding in October 2002. Yunnan Airlines Company and China Northwest Airlines Company were restructured as wholly-owned subsidiaries of CEA Holding after the merger and renamed as China Eastern Air Yunnan Company, or CEA Yunnan, and China Eastern Air Northwest Company, or CEA Northwest, respectively. CEA Northwest is based in Xi'an, Shaanxi Province in China with approximately 30 jet aircraft and serves primarily the western region of China. CEA Yunnan is based in Kunming, Yunnan Province in China with approximately 26 jet aircraft and serves primarily the southwestern region of China. The airline operations conducted by CEA Yunnan and CEA Northwest previously competed with our Company, in particular, on the Shanghai-Wenzhou route, Shanghai-Harbin route, Shanghai-Qingdao route, Shanghai-Changsha route, Changchun-Kunming route, Changsha-Ningbo route, Changsha-Kunming route and Changsha-Nanjing route.

In order to further expand our business and enhance our market competitiveness, we acquired from CEA Holding certain selected assets and liabilities relating to the aviation businesses of CEA Yunnan and CEA Northwest pursuant to a conditional assets transfer agreement, or Acquisition Agreement, entered into by our Company, CEA Holding, CEA Yunnan and CEA Northwest on May 12, 2005. The certain selected assets acquired by our Company included aircraft, engines and aviation equipment and facilities, certain employees and operating contracts, and other fixed and current assets (whether owned or leased assets). We also assumed aggregate debts of RMB9,421 million. We expressly did not assume certain legal liabilities. Following the completion of the acquisitions of these assets and liabilities in June 2005, our Company assumed and took over the aviation operations and businesses previously carried out by CEA Yunnan and CEA Northwest in accordance with the Acquisition Agreement. The air routes of CEA Yunnan and CEA Northwest were also injected into our Company with such assets and liabilities. The total consideration paid by our Company under the Acquisition Agreement was approximately RMB640 million in cash.

Under the Acquisition Agreement, each of CEA Holding, CEA Yunnan and CEA Northwest has undertaken that at any time after completion of the Acquisition Agreement, it will not, and will procure its respective subsidiaries and associated companies (including members of CEA Holding) not to, carry out, engage in or otherwise become involved or interested in any business which competes or may compete, either directly or indirectly, with our Company's aviation business. The undertaking is not made for any definite period.

The table below sets forth details of our operating fleet since December 31, 2003 (including our acquisition or assumption of ownership of or leases for 60 aircraft as part of our acquisition of certain selected assets and liabilities relating to the aviation businesses of CEA Yunnan and CEA Northwest in 2005) and planned additions for the year 2007 and 2008:

	No. of Aircraft Owned and under Finance Leases	**No. of Aircraft under Operating Leases**	**No. of Aircraft Owned and under Finance Leases**	**No. of Aircraft under Operating Leases**	**No. of Aircraft Owned and under Finance Leases**	**No. of Aircraft under Operating Leases**	**No. of Aircraft Owned and under Finance Leases**	**No. of Aircraft under Operating Leases**	**Planned Additions***	
	2003		**2004**		**2005**		**2006**		**2007**	**2008**
A340-600	3	—	5	—	5	—	5	—	—	—
A340-300	5	—	5	—	5	—	5	—	—	—
A330-300	—	—	—	—	—	—	—	7	5	3
A330-200	—	—	—	—	—	—	—	3	1	1
A300-600	7	5	7	3	10	3	9	—	—	—
A310	—	—	—	—	3	—	—	—	—	—
A321	—	—	2	—	4	—	6	—	4	5

A320	20	10	25	10	37	26	37	26	2	8
A319	—	10	—	10	—	10	3	10	2	2
MD-90	9	—	9	—	9	—	9	—	—	—
MD-82	—	3	—	3	—	3	—	—	—	—
B737NG	—	—	—	—	—	—	—	—	—	—
B737-800	—	—	—	—	—	3	—	7	—	1
B737-700	4	7	4	7	8	14	14	15	2	1
B737-300	3	3	3	3	13	6	13	10	—	—
B767-300	—	—	—	—	3	—	3	—	—	—
B787	—	—	—	—	—	—	—	—	—	4
EMB145	—	—	—	—	3	—	7	—	3	—
CRJ-200	—	2	—	—	5	—	5	—	—	—
A300F	—	—	—	1	—	2	1	1	—	—
B747F	—	—	—	—	—	2	1	2	1	—
MD-11F	6	—	6	—	6	—	6	—	—	—
Total	**97**		**103**		**180**		**205**		**20**	**25**

On December 27, 2006, our Board of Directors passed a resolution to dispose of certain aged aircraft and related flight equipment in the forthcoming 12-months in light of the poor market reception and the high maintenance cost of these aircraft. These aircraft together with the related flight equipment and spare parts have been classified as non-current assets held for sale as of December 31, 2006. Prior to the reclassification, a valuation deficit of RMB1,035 million for these assets was recognized in the income statement as a result of the asset revaluation. For more details, see Note 35 to our audited consolidated financial statements.

On March 14, 2006, we entered into an official sponsorship agreement with the Bureau of 2010 Expo Shanghai (the "Bureau"), which designated our Company as the exclusive airline passenger carrier in China to sponsor the 2010 Shanghai Expo. Pursuant to the agreement, we are entitled to a number of rights, including the use of the Bureau's logos and trademarks and the slogan "Better City, Better Life", and priority to purchase advertising space at the Expo site. We are also able to enjoy the privileges of being a market development participant of the World Expo. The total sponsorship fee under the agreement is RMB320 million, of which RMB160 million will be paid in cash in installments and the remaining RMB160 million will be settled by value-in-kind services. See Note 14(b) to our audited consolidated financial statements for details. As part of our five-year World Expo service strategy, we have increased the number of our aircraft, expanded our route network, improved our in-cabin and ground services, and developed our aircraft maintenance and repair capabilities. We believe that, as the designated partner airline for World Expo 2010 Shanghai and with our core operations in Shanghai, one of China's principal air transportation hubs, we are well-positioned to enhance our brand image and overall operations.

B. Business Overview

Our Company is one of the three largest air carriers in China in terms of tonne-kilometers and number of passengers carried in 2006, and is the primary air carrier serving Shanghai, China's eastern gateway and largest city. We accounted for approximately 23.0% of the total commercial air traffic (as measured in tonne-kilometers) handled by Chinese airlines in 2006. We operate primarily from Shanghai's Hongqiao Airport and Pudong International Airport. In 2006, we accounted for 38.6% and 31.1% of all the flight traffic at Hongqiao Airport and Pudong International Airport, respectively. In 2006, we accounted for approximately 35.6% of the total passenger traffic volume and 19.4% of the total freight volume on routes to and from Shanghai. We have been consistently ranked as one of the best Chinese airlines in terms of service quality in each of the past seven years according to a poll conducted by the China Civil Aviation Association.

Compared to 2005, our traffic volume increased by approximately 28.5% in 2006. Our passenger traffic volume increase from 36,380.6 million passenger-kilometers in 2005 to 50,271.9 million passenger-kilometers in 2006, or 38.2%. Our cargo and mail traffic volume increase by 13.6% from 2,151.5 million tonne-kilometers in 2005 to 2,444.0 million tonne-kilometers in 2006. In 2006, our average on-time performance rate was approximately 83.3%, which was slightly higher than the industry average rate of 81.6% in China.

Airline Operations and Route Network

The following table sets forth our traffic revenues by activity for each of the five years ended December 31, 2006:

	Year Ended December 31,				
	2002	2003	2004	2005	2006
	RMB	RMB	RMB	RMB	RMB
			(in millions)		
Traffic Revenues					
Passengers	10,038	10,375	15,534	20,853	30,440
Cargo and mail	2,445	3,187	4,428	4,967	5,625
Total Traffic Revenues	12,483	13,562	19,962	25,820	36,065

Passenger Operations

The following table sets forth certain passenger operating statistics of our Company by geographic region for each of the five years ended December 31, 2006:

	2002	**2003**	**2004**	**2005**	**2006**
Passenger Traffic (millions of passenger kilometers)	18,206	18,003	27,581	36,381	50,272
Domestic	8,516	10,302	14,500	20,278	31,272
Hong Kong	2,234	1,934	3,038	3,284	3,522
International	7,457	5,767	10,043	12,819	15,478
ASK (millions)	27,963	29,780	41,599	52,428	70,468
Domestic	13,494	15,909	20,635	27,468	42,687
Hong Kong	3,650	3,692	4,857	5,288	5,554
International	10,819	10,178	16,107	19,672	22,227
Passenger Yield (passenger revenues/ passenger kilometers, in RMB)	0.55	0.57	0.56	0.57	0.61
Domestic	0.55	0.54	0.57	0.56	0.61
Hong Kong	0.86	0.84	0.74	0.76	0.71
International	0.46	0.53	0.50	0.54	0.58
Passenger Load Factor (%)	65.11	60.45	66.30	69.39	71.34
Domestic	63.11	64.75	70.27	73.82	73.26
Hong Kong	61.21	52.37	62.55	62.10	63.39
International	68.93	56.66	62.35	65.16	69.64

The primary focus of our business is the provision of domestic, Hong Kong regional and international passenger airline services. In 2006, our passenger operations generated revenues of approximately RMB30,440 million, or approximately 84.4% of our traffic revenues. We operated approximately 5,650 scheduled flights per week (excluding charter flights), serving a route network that covers 136 cities within China and abroad. In 2006, we operated approximately 423 routes.

In 2006, we operated approximately 4,480 domestic flights per week on 299 routes. Our domestic routes generated approximately 62.2% of our passenger revenues. Our most heavily traveled domestic routes generally link Shanghai to the large commercial and business centers of China, such as Beijing, Guangzhou and Shenzhen.

In 2006, we also operated approximately 460 flights per week on 19 routes to and from Hong Kong, originating from Shanghai and 18 other major cities in eastern, northern and western China. Our Hong Kong regional routes accounted for approximately 8.2% of our passenger revenues in 2006.

In 2006, we operated approximately 710 international flights per week on 105 routes, serving 43 cities in 17 countries, primarily linking Shanghai to major cities in Asian and Southeast Asian countries (such as Japan, Korea, India, Singapore, Thailand and Bangladesh) and certain strategic locations in Europe, the United States and Australia. In 2005, we successfully introduced three new international routes including Shanghai-Bombay, Shanghai-Moscow and Shanghai-Dhaka. In 2006, we gradually introduced passenger traffic routes, such as Shanghai-Frankfurt, Shanghai-New York, Beijing-Seoul, Hangzhou-Qingzhou and Weihai-Seoul, to further improve our route network. In

April 2007, we introduced a new international route, Shanghai-Maldives-Johannesburg, and we plan to launch more new routes, such as Hangzhou-Jizhou, at the end of 2007. Revenues derived from our operations on international routes accounted for approximately 29.6% of our passenger revenues. Revenues derived from our operations on our 22 routes to and from Japan accounted for approximately 11.8% of our passenger revenues and approximately 39.9% of our international passenger revenues in 2006.

Most of our international and Hong Kong regional flights and a substantial portion of our domestic flights either originate or terminate in Shanghai, the central hub of our route network. Our operations in Shanghai are conducted primarily at Hongqiao Airport and Pudong International Airport. All of our international flights to or from Shanghai originate or terminate at Pudong International Airport. Pudong International Airport is a newly constructed airport and is approximately 30 kilometers from the central business district of Shanghai.

We operate most of our flights through our three hubs located in eastern, northwestern and southwestern China, namely Shanghai, Xi'an and Kunming, respectively. We believe that we will benefit from the level of development and growth opportunities in eastern, northern and western China as a whole by providing direct services between various cities in those regions and between those regions and other major cities in China. The provincial hubs also enable us to provide convenient connections for passengers on certain flights to and from Shanghai. Aircraft used for regional operations are mainly maintained by us on site at the hubs, and our sales offices are also based at each provincial hub. In addition, we are also in the process of developing our operations in Beijing and Guangzhou as our principal bases for northern China and southern China, respectively.

Cargo and Mail Operations

The following table sets forth certain cargo and mail operating statistics of our Company by geographic region for each of the five years ended December 31, 2006:

	Year Ended December 31,				
	2002	**2003**	**2004**	**2005**	**2006**
Cargo and Mail Tonne-Kilometers (millions)	1,023	1,297	1,875	2,152	2,444
Domestic	206	258	328	410	575
Hong Kong	53	81	124	135	141
International	764	958	1,423	1,607	1,728
Weight of Cargo and Mail Carried (millions of kilograms)	345	460	664	776	893
Domestic	170	205	262	316	439
Hong Kong	39	57	85	92	96
International	136	198	317	348	359
Cargo and Mail Yield (cargo and mail revenues/cargo and mail tonne-kilometers, in RMB)	2.39	2.46	2.36	2.31	2.30

Our cargo and mail business generated revenues of approximately RMB5,625 million in 2006, representing approximately 15.6% of our traffic revenues for the year.

We must obtain from the CAAC the right to carry passengers or cargo on any domestic or international route. Our cargo and mail business generally utilizes the same route network used by our passenger airline business. China Cargo Airlines Co., Ltd. also maintains 32 cargo routes. We carry cargo and mail on our freight aircraft as well as in available cargo space on our passenger aircraft. Our most significant cargo and mail routes are international routes. Revenues derived from our operations on international cargo and mail routes accounted for approximately 77.9% of our total cargo and mail revenues in 2006.

The development of cargo operations is an important part of our Company's growth strategy. We have six MD-11 freight aircraft for cargo and mail operations, three of which were converted from passenger aircraft after the establishment of China Cargo Airlines Co., Ltd. We also have one Airbus A300F and two Boeing 747F freighters under short-term operating leases for our cargo operations in 2006.

Regulation

The PRC Civil Aviation Law provides the framework for regulation of many important aspects of civil aviation activities in China, including:

· the administration of airports and air traffic control systems;

· aircraft registration and aircraft airworthiness certification;

· operational safety standards; and

· the liabilities of carriers.

The Chinese airline industry is also subject to a high degree of regulation by the CAAC. Regulations issued or implemented by the CAAC encompass virtually every aspect of airline operations, including route allocation, domestic airfare, licensing of pilots, operational safety standards, aircraft acquisition, aircraft airworthiness certification, fuel prices, standards for aircraft maintenance and air traffic control and standards for airport operations. Although China's airlines operate under the supervision and regulation of the CAAC, they are accorded a significant degree of operational autonomy. These areas of operational autonomy include:

· whether to apply for any route;

· the allocation of aircraft among routes;

· the airfare pricing for the international and Hong Kong passenger routes;

· the airfare pricing within the limit provided by the CAAC for the domestic passenger routes;

· the acquisition of aircraft and spare parts;

· the training and supervision of personnel; and

· many other areas of day-to-day operations.

Although we have generally been allocated adequate routes in the past to accommodate our expansion plans and other changes in our operations, those routes are subject to allocation and re-allocation in response to changes in governmental policies or otherwise at the discretion of the CAAC. Consequently, we cannot assure you that our route structure will be adequate to satisfy our expansion plans.

The CAAC has established regulatory policies intended to promote controlled growth of the Chinese airline industry. We believe those policies will be beneficial to the development of and prospects for the Chinese airline industry as a whole. Nevertheless, those regulatory policies could limit our flexibility to respond to changes in market conditions, competition or our cost structure. Moreover, while our Company generally benefits from regulatory policies that are beneficial to the airline industry in China as a whole, the implementation of specific regulatory policies may from time to time materially and adversely affect our business operations.

Because our Company provides services on international routes, we are also subject to a variety of bilateral civil air transport agreements between China and other countries. In addition, China is a contracting state as well as a permanent member of the International Civil Aviation Organization, an agency of the United Nations established in 1947 to assist in the planning and development of the international air transportation. The International Civil Aviation Organization establishes technical standards for the international airline industry. China is also a party to a number of other international aviation conventions. The business operations of our Company are also subject to those international aviation conventions.

Domestic Route Rights. Chinese airlines must obtain from the CAAC the right to carry passengers or cargo on any domestic route. The CAAC's policy on domestic route rights is to assign routes to the airline or airlines suitable for a particular route. The CAAC will take into account whether an applicant for a route is based at the point of origin or termination of a particular route. This policy benefits airlines, such as our Company, that have a hub located at each of the active air traffic centers in China. The CAAC also considers other factors that will make a particular airline suitable for an additional route, including the applicant's safety record, previous on-time performance and level of service and availability of aircraft and pilots. The CAAC will consider the market conditions applicable to any given route before such route is allocated to one or more airlines. Generally, the CAAC will permit additional airlines to service a route that is already being serviced only when there is strong demand for a particular route relative to the available supply. The CAAC's current general policy is to require the passenger load factor of one or two airlines on a particular route to reach a certain level before another carrier is permitted to commence operations on such route.

Hong Kong Route Rights. Hong Kong routes and the corresponding landing rights were formerly derived from the Sino-British air services agreement. In February 2000, the PRC Government, acting through the CAAC, and Hong Kong signed the Air Transportation Arrangement between mainland China and Hong Kong. The Air Transportation Arrangement provides for equal opportunity for airlines based in Hong Kong and mainland China. Competition from airlines based in Hong Kong increased after the execution of the Air Transportation Arrangement. The CAAC allocates route and landing rights among the eight Chinese airlines currently permitted to fly to Hong Kong. The CAAC normally will not allocate an international route or a Hong Kong route to more than one domestic airline unless certain criteria, including minimum load factors on existing flights, are met. There is more than one Chinese airline company on certain of our Hong Kong routes.

The CAAC and the Economic Development and Labor Bureau of Hong Kong recently announced that they have reached an agreement to further expand the Air Transportation Arrangement. This agreement will increase the routes between Hong Kong and mainland China to expand coverage to most major cities in mainland China. The capacity limits for passenger and/or cargo services on most routes will also be gradually lifted. Beginning from the winter of 2007, each side can designate three airline companies to operate passenger and/or cargo flights and another airline company to operate all-cargo flights on the majority of the routes between Hong Kong and mainland China.

International Route Rights. International route rights, along with the corresponding landing rights, are derived from air services agreements negotiated between the PRC Government, acting through the CAAC, and the government of the relevant foreign country. Each government grants to the other the right to designate one or more domestic airlines to operate scheduled services between certain points within each country. Upon entering into an air services agreement, the CAAC seeks applications from the eight Chinese airlines currently approved to fly international passenger routes. The CAAC awards the relevant route to an airline based on various criteria, including:

- availability of appropriate aircraft and flight personnel;
- safety record;
- on-time performance; and
- hub location.

Although hub location is an important criterion, an airline may be awarded a route which does not originate from an airport where it has a hub. The route rights awarded do not have a fixed expiry date and can be terminated at the discretion of the CAAC.

Airfare Pricing Policy. The PRC Civil Aviation Law provides that airfares for domestic routes are determined jointly by the CAAC and the agency of the State Council responsible for price control, primarily based upon average airline operating costs and market conditions. From February 1999 to March 2001, all domestic airlines were required to adhere to unified domestic airfares published by the CAAC from time to time and discounted sales were prohibited. In 2001, the CAAC gradually relaxed its control over domestic airfare pricing and, effective March 1, 2001, domestic airlines were permitted to offer discounts on several major domestic routes.

On March 17, 2004, China's State Council approved the Pricing Reform Plan for the Domestic Civil Aviation Industry, or the Pricing Reform Plan, effective April 20, 2004. Pursuant to the Pricing Reform Plan, the governmental authorities responsible for price control no longer directly set the airfares for domestic routes, but indirectly control the airfares for domestic routes by setting basic airfare levels and permitted ranges within which the actual fares charged by Chinese airlines can deviate from such basic airfare levels. Chinese airlines are able to set their own airfares for their domestic routes within the permitted ranges and adopt more flexible sales policies to promote their services.

The CAAC and the National Development and Reform Commission, or NDRC, jointly publish the pricing guidelines from time to time, which set forth the basic airfare levels and permitted ranges. Pursuant to the current pricing guidelines, the basic airfares for domestic routes are the published airfares implemented by Chinese airlines immediately prior to the approval of the Pricing Reform Plan (the average basic airfare for domestic routes is RMB0.75 per passenger-kilometer). Except for certain domestic routes, the actual airfare set by each Chinese airline for its domestic routes cannot be 25% higher and 45% lower than the basic airfare. Domestic routes that are not subject to the deviation range restrictions include short-haul routes between cities in the same province or autonomous region, or between a municipality and adjacent provinces, autonomous regions or another municipality. Certain tourist routes and routes served by only one Chinese airline are not subject to the bottom range restriction. The CAAC and the NDRC will announce the routes that are not subject to the deviation range restrictions through the airfare information system known as Airtis.net. Chinese airlines may apply to the CAAC and the NDRC for exemption from the bottom range restriction for a particular route. Chinese airlines are also required to file the actual airfare they set for their domestic routes within the ranges through Airtis.net 30 days prior to its implementation.

The CAAC and the NDRC will regularly review the average operating costs of Chinese airlines, and may adjust the basic airfare for particular domestic routes which, in their view, is not at a reasonable level. We expect that, as reforms continue in 2007, we will have more flexibility in operating our aviation business in the future. The promotion by Chinese regulators of a regulated and orderly market and a fair and positive competition mechanism will also provide a favorable environment for the growth of our business.

Under the PRC Civil Aviation Law, maximum airfares on Hong Kong and international routes are set in accordance with the terms of the air services agreements pursuant to which these routes are operated. In the absence of an air services agreement, airfares are set by the airlines themselves or by the CAAC with reference to comparable market prices, taking into account the international airfare standards established through the coordination of the International Air Transport Association, which organizes periodic air traffic conferences for the purpose of coordinating international airfares. Discounts are permitted on Hong Kong and international routes. For the airline industry in China as a whole, the airfare per kilometer is substantially higher for Hong Kong and international routes than for domestic routes.

Acquisition of Aircraft and Spare Parts. Most Chinese airlines are required to purchase their aircraft, aircraft spare parts and other aviation equipment through the China Aviation Supplies Import & Export Group Corporation, or the CASC Group, an entity controlled by the CAAC. If a Chinese airline plans to acquire an aircraft, the airline must first seek approval from the CAAC and NDRC and must, as a condition of approval, provide specific acquisition plans, which are subject to modification by the CAAC and NDRC. If approval of an aircraft acquisition is obtained, the airline negotiates the terms of the acquisition with the manufacturer together with the CASC Group because the CASC Group possesses the license required to import or export aircraft and is entitled to receive a commission. Our Company is permitted to import aircraft, aircraft spare parts and other equipment for our own use from manufacturers through EAIEC**,** which is 55% owned by CEA Holding and 45% owned by our Company, without the participation of CASC. This gives us freedom in rationalizing our maintenance practices by allowing us to maintain a relatively lower overall inventory level of aircraft parts and equipment than we otherwise would have to maintain. We are still required to obtain an approval from the NDRC for any import of aircraft. We generally pay a commission to EAIEC in connection with these imports.

Domestic Fuel Supply and Pricing. The Civil Aviation Oil Supply Company, or CAOSC, which is controlled by the CAAC, is currently the dominant civil aviation fuel supply company in China. We currently purchase a significant portion of our domestic fuel supply from CAOSC. The PRC Government determines the fuel price at which the CAOSC acquires fuel from domestic suppliers and the CAAC issues a guidance price. The retail price at which the CAOSC resells fuel to airline customers is set within a specified range based on this guidance price.

Safety. The CAAC has made the improvement of air traffic safety in China a high priority. The CAAC is responsible for the establishment of operational safety, maintenance and training standards for all Chinese airlines, which have been formulated based on international standards. Each Chinese airline is required to provide flight safety reports to the CAAC, including reports of flight incidents or accidents involving its aircraft which occurred during the relevant reporting period and other safety related problems. The CAAC conducts safety inspections on each airline periodically.

The CAAC oversees the training of most Chinese airline pilots through its operation of the pilot training college. The CAAC implements a unified pilot certification process applicable to all Chinese airline pilots and is responsible for the issuance, renewal, suspension and cancellation of pilot licenses. Each pilot is required to pass the CAAC-administered examinations before obtaining a pilot license and is subject to an annual examination in order to have such certification renewed.

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

Security. The CAAC establishes and oversees the implementation of security standards and regulations based on the PRC laws and standards established by international civil aviation organizations. Each airline is required to submit to the CAAC an aviation security handbook describing specific security procedures established by the airline for the day-to-day operations and security training for staff. Such security procedures must be formulated based on the relevant CAAC regulations. Chinese airlines that operate international routes must also adopt security measures in accordance with the requirements of the relevant international agreements. We believe that our Company is in compliance with all applicable security regulations.

Noise and Environmental Regulation. All airlines and airports in China are required to comply with noise and environmental regulations of the State Environmental Protection Agency that are modeled on international standards. The CAAC regulations allow Chinese airports to refuse take-off and landing rights to any aircraft that does not comply with State noise regulations. We believe that our Company is in compliance with all applicable noise and environmental regulations.

Chinese Airport Policy. Prior to September 2003, all civilian airports in China were operated directly by the CAAC or by provincial or municipal governments. In September 2003, as part of the restructuring of the aviation industry in China, the CAAC handed over 93 civilian airports to provincial or municipal governments. The CAAC retained the authority to determine the take-off and landing charges, as well as charges on airlines for the use of airports and airport services. Prior to 2004, Chinese airlines were generally required to collect from their passengers on behalf of the CAAC a levy for contribution to the civil aviation infrastructure fund, which was used for improving China's civilian airport facilities. Our revenue for the previous years is shown net of this levy. In 2003, the levy was 5% of domestic airfares and 2% of international airfares. The levy was waived by the CAAC from May 1, 2003 to December 31, 2003. With effect from September 2004, the civil aviation infrastructure levies, now paid to the Ministry of Finance, have been reflected in the ticket prices of Chinese airlines rather than collected as a separate levy.

Limitation on Foreign Ownership. The CAAC's present policies limit foreign ownership in Chinese airlines. Under these limits, non-Chinese residents and Hong Kong, Macau or Taiwan residents cannot aggregately hold a majority of our total outstanding shares. Currently, approximately 32.2% of our total outstanding shares are held by non-Chinese residents and Hong Kong, Macau or Taiwan residents (excluding the qualified foreign institutional investors that are approved to invest in the A Share market of the PRC).

Competition

Domestic. Domestic competition from other Chinese airlines has been increasing recently as our competitors have increased capacity and expanded operations by adding new routes or additional flights to existing routes and acquiring other airlines. In addition, we face increasing competition from entrants to our domestic markets as new investments into China's civil aviation industry are made following the CAAC's relaxation of certain private-sector investment rules in July 2005. We expect that competition in the future from other Chinese airlines on our routes will further increase as the CAAC promotes controlled competition in order to advance the growth of the domestic airline industry as a whole. Our Company competes against our domestic competitors primarily on the basis of safety, quality of service and frequency of scheduled flights. With the combination of our dominant position in Shanghai, our route network and our continued commitment to safety and service quality, we believe that our Company is well-positioned to compete against our domestic competitors in the growing airline industry in China.

There are currently approximately 14 passenger airlines operating in China, and our Company competes with many of them on various domestic routes. All of these airlines operate under the regulatory supervision of the CAAC. In July 2005, the CAAC introduced new rules to further open the civil aviation industry to domestic investors, including private-sector investors, which may result in the establishment of more new Chinese airlines and create more competition. Our Company, Air China Limited, or Air China, which is based in Beijing and listed on the Hong Kong Stock Exchange and the London Stock Exchange, and China Southern Airlines Company Limited, or China Southern, which is based in Guangzhou and listed on the Hong Kong Stock Exchange and the New York Stock Exchange, are the three leading air carriers in China, both in terms of revenue tonne-kilometers and size of operations. Each of these three airlines operates at least 400 routes and has a fleet of at least 200 jet aircraft. As of December 31, 2006, our Company, Air China and China Southern accounted for 23.0%, 28.8% and 26.3%, respectively, of the total commercial air traffic (as measured in tonne-kilometers) handled by Chinese airlines.

Each of the domestic airlines competes against other airlines operating the same routes or flying indirect routes to the same destinations. Our principal competitors in the domestic market are China Southern and Air China, which also provide transportation services on some of our routes, principally routes originating from the major air transportation hubs in China, such as Shanghai, Guangzhou and Beijing. Some of these routes are among our most heavily traveled routes. Since most of the major domestic airlines operate routes from their respective hubs to Shanghai, our Company also competes against virtually all of the major domestic airlines on these routes. The number of airlines operating flights to and from Shanghai has increased significantly in recent years. We also face domestic competition from Shanghai Airlines, an airline based in Shanghai which is smaller than our Company. Competition between Shanghai Airlines and us increases as Shanghai Airlines expands its long-haul capacity and operates routes to more cities served by our Company.

Hong Kong. Our high yielding Hong Kong routes are highly competitive. The primary competitor on our Hong Kong routes is Hong Kong Dragon Airlines Limited, or Dragonair. We currently operate approximately 460 flights per week on routes between 19 Chinese cities and Hong Kong. Dragonair competes with us on several of these routes. Moreover, in April 2003, Cathay Pacific Airways Limited, or Cathay, obtained licenses to fly to Beijing, Shanghai and Xiamen in China. Cathay commenced its services on the Hong Kong-Beijing, Hong Kong-Shanghai and Hong Kong-Xiamen routes in December 2003, January 2005 and February 2005, respectively. With Cathay commencing its operations on the Hong Kong-Shanghai route, we face more intensified competition on this route. In addition to the frequency and convenience of our flights and the number of routes offered, our Company's competitive strategy for the Hong Kong routes also stresses safety and service quality. The new Air Transportation Arrangement signed between the PRC Government and the administrative government of Hong Kong in February 2000 provides for equal opportunity for airlines based in Hong Kong and mainland China. As a result, Dragonair has increased the frequency of its flights on several of our Hong Kong routes and intensified competition.

On September 28, 2006, Cathay, which previously owned approximately 17.79% of Dragonair, acquired the remaining 82.21% shareholding in Dragonair, turning Dragonair into a wholly-owned subsidiary of Cathay. In connection with the acquisition, Cathay doubled its shareholding in Air China to 20% and Air China acquired approximately 10.16% equity interest in Cathay. Cathay and Air China also entered into an agreement to enhance cooperation between them in a number of operational areas, including operating all the passenger services of Cathay and Air China between Hong Kong and mainland China as joint venture routes under code-share and revenue and cost-pooling arrangements. Cathay's acquisition of Dragonair and enhanced cooperation with Air China may further intensify the competition on the routes between Hong Kong and mainland China and impose greater competitive pressure on the other airline companies operating on these routes.

At present, our Hong Kong routes benefit from traffic between Hong Kong and mainland China ultimately originating in Taiwan. During the Lunar Chinese New Year peak travel season from late-January to mid-February in 2003, the PRC Government allowed special chartered flights between Shanghai and Taiwan for the first time. During the Lunar Chinese New Year peak travel seasons from late-January to mid-February in 2006 and 2007, respectively, airlines from both mainland China and Taiwan (including our Company) operated 72 and 96 non-stop direct chartered flights between selected cities of mainland China and Taiwan. In 2006, the PRC Government allowed for the first time direct flights during the Mid-Autumn Festival holiday from late-September to early-October. During this holiday, airlines from both mainland China and Taiwan (including our Company) operated 22 non-stop direct chartered flights on passenger traffic routes that included Beijing-Taipei, Shanghai-Taipei, Guangzhou-Taipei, Xiamen-Gaoxiong (Kaohsiung), and Xiamen-Taipei. In addition, direct flights were permitted for the first time during the observance of Qingming (Ching Ming) Festival from late-March to early-April in 2007. During this period, 11 airlines from both mainland China and Taiwan (including our Company) operated a total of 42 direct flights on the same passenger traffic routes. Although regular direct flights between Taiwan and mainland China are still not permitted, our results of operations on Hong Kong routes could be materially and adversely affected if direct flights between Taiwan and mainland China are permitted in the future. We cannot assure you that our Company can obtain sufficient Taiwan-mainland China routes or that the yields on these routes would be adequate to offset any material adverse effect on our revenues derived from operation on our Hong Kong routes. Our Company also faces competition from Dragonair in our Hong Kong cargo operations.

In 1995, China National Aviation Corporation, or CNAC, which is controlled by Air China, acquired an interest in Air Macau. Air Macau started to operate routes in 1996 between Macau and mainland China, including routes to cities in mainland China such as Beijing, Shanghai, Xiamen and Wuhan. Air Macau also operates routes between Macau and Taiwan, including flights which allow passengers to travel between mainland China and Taiwan through Macau without changing planes in Macau. Air Macau’s routes provide an alternative to our Hong Kong routes for passengers traveling between Taiwan and mainland China. The airfares on some of Air Macau’s routes are significantly lower than airfares on our Company’s comparable routes.

International. We compete with Air China, China Southern and many other well-established foreign carriers on our international routes. Most of our international competitors are very well-known international carriers and are substantially larger than us and have substantially greater financial resources than we do. Many of our international competitors also have significantly longer operating histories and greater name recognition than we do. Some international passengers, who may perceive these airlines to be safer than Chinese airlines in general, may prefer to travel on these airlines. In addition, many of our international competitors have more extensive sales networks and utilize more developed reservation systems than ours, or engage in promotional activities, such as frequent flyer programs, that may be more popular than ours and effectively enhance their ability to attract international passengers. We also face significant competition in our international cargo operations. Moreover, China and the United States entered into an air service agreement on July 24, 2004. Pursuant to this agreement, five additional airlines from each country are allowed to serve the China-U.S. market over the next few years. It is expected that there will be a significant increase in China-U.S. air services over the next few years due to this agreement, which would further intensify competition in this market.

Air China operates the largest number of international routes among all Chinese airlines. Beijing, the hub of Air China’s operations, is the destination for most international flights to China. We compete with Air China, All Nippon Airways, Japan Airlines, Shanghai Airlines, China Southern and Northwest Airlines, Inc. on our passenger routes to Japan. On our Korean routes, we compete with Asiana Airlines, Korean Air, China Southern and Air China. Our primary competition on our flights to Southeast Asia comes from Thai Airways International, Singapore Airlines and China Southern. On our passenger flights to the United States, our principal competitors include Northwest Airlines, Inc., United Airlines, American Airlines, Air China and China Southern. On our European routes, our competitors include Air China, the Air France-KLM Group, Virgin Atlantic Airways, British Airways and Lufthansa German Airlines. We compete with Air China and Qantas Airways Ltd. on our Australian routes. Our Company competes in the international market on the basis of price, service quality, frequency of scheduled flights and convenient sales arrangements. To improve our competitive position in international markets, we have established additional dedicated overseas sales offices, launched our own frequent flyer program, participated in the "Asia Miles" frequent flyer program which is popular in Asia, and entered into code-sharing arrangements with a number of foreign airlines. We have also improved our online reservation and payment system.

Maintenance and Safety

The rapid increase in air traffic volume in China in recent years has put pressure on many components of the Chinese airline industry, including air traffic control systems, the availability of qualified flight personnel and airport facilities. In recent years, the CAAC has placed increasing emphasis on the safety of Chinese airline operations and has implemented a number of measures aimed at improving the safety record of the airlines. Our Company's ability to provide safe air transportation in the future depends on the availability of qualified and experienced pilots in China and the improvement of maintenance services, national air traffic control and navigational systems and ground control operations at Chinese airports. Our Company has a good safety record and regards the safety of our flights as the most important component of our operations.

Maintenance Capability. We currently perform regular repair and maintenance checks for all of our aircraft. We are able to perform D1 checks on our Boeing 737 aircraft and C checks on MD-82, Airbus A320, A340-300 and A300-600 aircraft. We also perform certain maintenance services for other Chinese airlines. Our primary aircraft maintenance base is at Hongqiao Airport. We have additional maintenance bases at Pudong International Airport and each of our provincial hubs. Our maintenance staff in Shanghai supervises the operation of our regional maintenance facilities. Our Company currently employs approximately 5,595 workers as maintenance and engineering personnel. Some of our aircraft maintenance personnel participated in the manufacturer training and support programs sponsored by Airbus Industries G.I.E., or Airbus, and Boeing Corporation, or Boeing. In order to enhance our maintenance capabilities and to reduce our maintenance costs, we have, over the past few years, acquired additional maintenance equipment, tools and fixtures and other assets, such as airborne testing and aircraft data recovery and analysis equipment. Our Company's avionics electronic equipment is primarily maintained and repaired at our electronic maintenance equipment center located in Shanghai, which was set up in cooperation with Honeywell, Inc. and is one of the largest and most advanced avionic electronic facilities in China.

We entered into a joint venture with Honeywell International Inc., formerly Allied Signal Inc., in Shanghai for the purpose of performing maintenance and repairs on aircraft wheel assemblies and brakes. We also entered into an agreement with Singapore Aviation Services Company, or SASCO, for the provision of additional maintenance services by SASCO to our Company. Since October 1997, we have operated a maintenance hangar at Hongqiao Airport which has the capacity to house two wide-body aircraft. Our Company and Rockwell Collins International Inc. of the United States have also co-established Collins Aviation Maintenance Service Shanghai Limited, which is primarily engaged in the provision of repair and maintenance services for avionics and aircraft entertaining facilities in China. Our Company and Rockwell Collins International Inc. hold 35% and 65%, respectively, of the equity interests in the joint venture. Moreover, in November 2002, our Company, jointly with Aircraft Engineering Investment Limited, established Shanghai Eastern Aircraft Maintenance Limited, in which our Company holds 60% of the equity interests, to provide supplemental avionics and other maintenance services to our Company. STA, established in 2004 between our Company and Singapore Technologies Aerospace Ltd. under a joint venture agreement dated March 10, 2003, also provides us with aircraft maintenance, repair and overhaul services.

The enhancement of our maintenance capabilities allows our Company to perform various maintenance operations in-house and continue to maintain lower spare parts inventory levels.

Safety. The provision of safe and reliable air services for all of our customers is one of our primary operational objectives. Our Company implements uniform safety standards and safety-related training programs in all operations. Our flight safety management division monitors and supervises our Company's flight safety. We have had a flight safety committee since the commencement of our business, comprised of members of our senior management, to formulate policies and implement routine safety checks at our Shanghai headquarters and all provincial hubs. The flight safety committee meets monthly to review our overall operation safety record during the most recent quarter and to adopt measures to improve flight safety based upon these reviews. We have also implemented an employee incentive program, using a system of monetary rewards and discipline, to encourage compliance with the CAAC safety standards and our safety procedures. We periodically evaluate the skills, experience and safety records of our pilots in order to maintain strict control over the quality of our pilot crews.

The management of each of our provincial hub operations is responsible for the flight safety operations at the respective hub under the supervision of our flight safety management division. We prepare monthly safety bulletins detailing recent developments in safety practices and procedures and distribute them to each of our flight crew, the maintenance department and the flight safety management department. The CAAC also requires our Company to prepare and submit semi-annual and annual flight safety reports.

All of our jet passenger aircraft pilots participated in the manufacturer training and support programs sponsored by Airbus and Boeing and are required to undergo recurrent flight simulator training and to participate in a flight theory course periodically. Our Company uses flight simulators for MD-82, A300-600R, A320 and A330/340 aircraft at our own training facility, the training facility located in the CAAC training center or overseas training facilities.

Fuel Supplies

Fuel costs represented approximately 33.3% of our operating expenses in 2006. We currently purchase a significant portion of the aviation fuel for our domestic routes from regional branches of the CAOSC. Fuel costs in China are affected by costs at domestic refineries and limitations in the transportation infrastructure, as well as by insufficient storage facilities for aviation fuel in certain regions of China. We purchase a portion of the aviation fuel for our international routes from foreign fuel suppliers located at the destinations of these routes, generally at international market prices.

In 2006, our fuel expenses increased 53.1% as a result of increased weighted average domestic and international fuel prices and the expansion of our fleet. In particular, in 2006, the weighted average fuel prices paid by our Company increased by approximately 33.6%.

Ground Facilities and Services

The center of our operations is Shanghai, one of China's principal air transportation hubs. Our Shanghai operations are based at Hongqiao Airport and Pudong International Airport. We currently also operate from various other airports in China, including Yaoqiang Airport in Jinan, Lukou Airport in Nanjing, Liuting Airport in Qingdao, Luogang Airport in Hefei, Changbei Airport in Nanchang, Wushu Airport in Taiyuan, Zhengding Airport in Shijiazhuang, Lishe Airport in Ningbo, Tianhe Airport in Wuhan, Wujiaba Airport in Kunming and Xianyang Airport in Xi'an. We own hangars, aircraft parking and other airport service facilities at Hongqiao Airport and Pudong International Airport and lease from CEA Holding certain buildings at Hongqiao Airport where our principal executive offices are located.

We have our own ground services and other operational services, such as aircraft cleaning and refueling and the handling of passengers and cargo for our operations at Hongqiao Airport and Pudong International Airport. We also provide ground services for many other airlines that operate to and from Hongqiao Airport and Pudong International Airport. At other airports served by our Company, we generally contract for ground services with these airports or the principal airlines based at these airports for fees and other charges which are typically based on passenger or cargo volume or aircraft tonnage.

In-flight meals and other catering services for our Shanghai-originated flights are provided primarily by Shanghai Eastern Air Catering Limited Liability Company, a joint venture company affiliated with CEA Holding. We generally contract with local catering companies for flights originating from other airports. We have improved the quality of our in-flight meal service in recent years.

We incur certain airport usage fees and other charges for services performed by the airports where our Company operates, such as air traffic control charges, take-off and landing fees, aircraft parking fees and fees payable in connection with the use of passenger waiting rooms and check-in counter space. At domestic airports, such fees are generally charged at rates prescribed by the CAAC, which are lower than rates generally in effect at airports outside

China.

Marketing and Sales

Passenger Operations. Our marketing strategy with respect to passenger operations is primarily aimed at increasing our market share for all categories of air traveler. With respect to our Hong Kong and international routes, we are permitted to market our services on the basis of price. We also have limited flexibility in setting our airfares for domestic routes after the implementation of the Pricing Reform Plan in April 2004, and therefore are able to adjust our domestic airfares in response to market demand. As part of our overall marketing strategy, we emphasize our commitment to safety and service quality. We believe that emphasis on safety is a critical component of our ability to compete successfully. In order to improve our customer services, we participated in joint cabin crew training and exchange programs with foreign airlines, including Asiana Airlines and Japan Airlines.

We have also adopted customized strategies to market our services to particular travelers. We seek to establish long-term customer relationships with business entities that have significant air travel requirements. In order to attract and retain business travelers, we focus on frequency of flights between major business centers, convenient transit services and an extensive sales network. We launched our “Golden Swallow” frequent flyer program in 1998 and joined the “Asia Miles” frequent flyer program in April 2001 to attract and retain travelers. In August 2003, we changed the name of our frequent flyer program to “Eastern Miles” and introduced a series of new services, including, among others, instant registration of membership and mileage, online registration of mileage, and accumulation of mileage on expenses at certain hotels and restaurants that are our strategic partners. As a result of our continual efforts to develop the “Eastern Miles” program, the number of frequent flyers surpassed 5.6 million in 2006, with a flight-taking rate of 8.1%, bringing the influence of our products into full play. The special services hotline “95108” call centre was established and came into operation in 2004.

In 2000, we launched the “China Eastern Airlines-Great Wall” co-branded credit card jointly with the Bank of China, which provides our customers with benefits such as airfare discounts, hotel room reservation packages and increased baggage allowances. In 2004, working with partner hotels, we launched our Eastern Holiday product series to attract more leisure travelers. In addition, we continued to promote our “China Eastern Express” services on our Shanghai-Hong Kong and Shanghai-Beijing routes and our “China Shuttle” transit services. Our “China Eastern Express” services (including “BTBT” and “Shanghai Beijing Express”) provide more scheduled flights on some of our heavily traveled routes, such as Shanghai-Hong Kong and Shanghai-Beijing, compared with our other routes. Our “China Shuttle” services provide expedited transit services at Hongqiao Airport and Pudong International Airport for transit travelers on domestic routes and certain international routes, significantly enhancing our customer service. We streamlined the transfer and connection procedures, rationally allocated flights, and also introduced different fares for connection flights to meet the needs of different travelers. In 2005, we launched international routes originating from Shenyang, Dalian, Xi’an, Shenzhen, Chongqing, Chengdu and Harbin under internal code-sharing arrangements. We also introduced the “Single Check-in for Transit Passengers and Luggage” service in 23 cities including Shantou and Xiamen. All these efforts improved the quality of our transit services and, as a result, the number of passengers who used our transit services exceeded 850,000 and 1,120,000 persons/time in 2005 and 2006, respectively. In June 2004, we officially introduced our China Eastern Service Scheme to the public at large. Under this scheme, we devote efforts to flight scheduling, assurance and maintenance and enhance our non-regular services.

We have entered into code-sharing arrangements with American Airlines, Japan Airlines, Korean Airlines, Asiana Airlines, Qantas Airways, Air France, Thai Airways, Air Europa and Shanghai Airlines. We are also contemplating more code-sharing arrangements with other airlines and plan to continue to strengthen our existing cooperation with other international airlines, such as Air Canada, in the near future.

Our advertising, marketing and other promotional activities include the use of radio, television and print advertisements. We plan to continue to use advertising and promotional campaigns to increase sales on new routes and competitive routes.

In 2002, we upgraded our online ticket booking and payment system to facilitate customer purchases of tickets via the Internet. We continue to encourage our customers to book and purchase tickets via the Internet. We also maintain an extensive domestic network of sales agents and representatives in order to promote in-person ticket sales and to assist customers. The majority of our airline tickets are sold by domestic and international sales agents. Our tickets are sold throughout China through approximately 7,387 sales agents and travel agents who have contractual relationships with us. Currently, our direct domestic ticket sales are handled primarily through employees based at our ticket counters located at Hongqiao Airport and Pudong International Airport in Shanghai and in Anhui, Jiangsu, Zhejiang, Jiangxi, Shandong, Shanxi, Hebei, Hubei, Yunnan and Shaanxi provinces, as well as at the airports in Beijing, Chengdu, Fuzhou, Guangzhou, Hangzhou, Ningbo, Shenzhen, Xiamen and Yantai. Direct sales are also promoted by the availability of our telephone reservation and confirmation services. In addition to our domestic sales agents, we maintain overseas representative offices in Chicago, Los Angeles, Seattle, New York, Vancouver, Madrid, Paris, London, Frankfurt, Munich, Moscow, Sydney, Melbourne, Tokyo, Osaka, Nagasaki, Fukuoka, Nagoya, Okinawa, Niigata, Sapporo, Kagoshima, Hiroshima, Okayama, Matsuyama, Singapore, Bangkok, Seoul, Delhi, Kuala Lumpur and Hong Kong, which facilitate the sale of international and Hong Kong air tickets and provide reservation confirmation and other services. The establishment of our Hong Kong operations division in 2005 also facilitates our marketing and sales in Hong Kong. In order to promote international ticket sales, we intend to increase our international sales force by expanding our overseas network of commissioned independent sales agents.

All of our direct passenger ticket sales are recorded on our computer systems. All Chinese airlines, including us, are required to use the passenger reservation service system provided by the CAAC's computer information management center, which is linked with the computer systems of major Chinese commercial airlines. We have also entered into membership agreements with several international reservation systems, including ABACUS, the largest computer reservation system in southeast Asia, TOPAS of Korea, SABRE, GALILEO and WORLDSPAN of the United States, AMADEUS of Europe, and INFINI and AXESS of Japan, which have made it easier for customers and sales agents to make reservations and purchase tickets for our international flights.

Cargo Operations. We maintain a network of cargo sales agents domestically and internationally. We established domestic cargo sales offices in Beijing, Shanghai, Xiamen and other major transportation hubs in China, and international cargo sales offices in Hong Kong, Tokyo, Seoul, Dallas, Seattle, Chicago, San Francisco, New York, Paris and our other overseas flight destinations. In 2005, we established our northern China, southern China, southeastern China and overseas sales management centers to improve coordination among our sales offices. We are also improving our cargo sales on passenger flights through full utilization of our existing passenger sales network.

Ancillary Airline Activities

In addition to our airline operations, we also generate commission revenues from tickets sold on behalf of other airlines. Commission rates for these sales are determined by the CAAC and are based on the price of the tickets sold.

Moreover, we derive revenues from the provision of airport ground services for airlines operating to or from Hongqiao Airport and Pudong International Airport, including aircraft cleaning, loading, unloading, storage and ground transportation of cargo and passenger luggage. At present we are the principal provider of these services at Hongqiao Airport and Pudong International Airport. We provide these services to foreign carriers generally pursuant to one-year renewable contracts. In 2006, we generated revenues of approximately RMB1,071 million from our airport ground services and cargo handling services.

Patents and Trademarks

We own or have obtained licenses to use various domestic and foreign patents, patent applications and trademarks related to our business. While patents, patent applications and trademarks are important to our competitive position, no single one is material to us as a whole.

We own various trademarks related to our business. The most important trademark is the service trademark of China Eastern Airlines Corporation Limited. All of our trademarks are registered in China.

Insurance

The CAAC purchases fleet insurance from PICC Property and Casualty Company Limited, or PICC, and China Pacific Property Insurance Company Ltd., on behalf of all Chinese airlines. PICC has reinsured a substantial portion of its aircraft insurance business through Lloyd's of London. The fleet insurance is subject to certain deductibles. The premium payable in connection with the insurance is allocated among all Chinese airlines based on the aircraft owned or leased by these airlines. Under the relevant PRC laws, the maximum civil liability of Chinese airlines for injuries to passengers traveling on domestic flights has been increased to RMB400,000 per passenger in March 2006, for which our Company also purchases insurance. As of July 31, 2006, the Convention for the Unification of Certain Rules for International Carriage by Air of 1999, or Montreal Convention, became effective in China. Under the Montreal Convention, carriers of international flights are strictly liable for proven damages up to 100,000 Special Drawing Rights and beyond that, carriers are only able to exclude liability if they can prove that the damage was not due to negligence or other wrongful act of the carrier (and its agents) or if the damage solely arose from the negligence or other wrongful act of a third party. We believe that we maintain adequate insurance coverage for the civil liability that can be imposed due to injuries to passengers under Chinese law, the Montreal Convention and any agreement we are subject to. We also maintain hull all risk, hull war risk and aircraft legal liability insurance, including third party liability insurance, of the types and in amounts customary for Chinese airlines. See also "Item 3. Key Information — Risk Factors — Insurance coverage and cost" for more information on our Company's insurance coverage.

C. Organizational Structure

See the section headed "Item 4. Information on the Company — Business Overview".

D. Property, Plants and Equipment

Fleet

In 2005, as part of our acquisition of certain selected assets and liabilities relating to the aviation businesses of CEA Yunnan and CEA Northwest, we acquired or assumed the ownership of or the leases for 60 additional aircraft. We also added 27 aircraft to our fleet through other transactions, including the purchase of two Airbus A321 aircraft and three EMB145 aircraft, the finance lease of five Airbus A320 aircraft, the operating lease of four Airbus A320 aircraft, seven B737-700 aircraft and three B737-800 aircraft, and the operating lease of one Airbus A300F freighter and two B747F freighters. Moreover, we entered into agreements to purchase five A319 aircraft (with engines), five EMB145 aircraft, 15 A320 series aircraft, two Boeing 747-400 freight aircraft, four Boeing 737 aircraft and 15 Boeing 787 aircraft, respectively. In 2006, we added 27 aircraft to our fleet, including the finance lease of three A319 aircraft, two A321 aircraft, six B737-700 aircraft, one B747F freighter and four EMB145 aircraft, and the operating lease of one B737-700 aircraft, three A330-200 aircraft and seven A330-300 aircraft. On December 27, 2006, our Board of Directors passed a resolution to dispose of certain aged aircraft and related flight equipment in the forthcoming 12-months in light of the poor market reception and the high maintenance cost of these aircraft. For more details, see Note 35 to our audited consolidated financial statements. We plan to continue to expand our scale in 2007 and to adjust and optimize our route network, thereby increasing our competitiveness and ability to create more attractive products and services to meet the needs of the market. We have continued to build our fleet and have introduced two A319 aircraft, two A320 aircraft, four A321 aircraft, one A330-200 aircraft, five A330-300 aircraft, two B737-700 aircraft, three EMB145 aircraft and one B747F aircraft, which were delivered to us and commissioned into service this year.

As of December 31, 2006, we had a fleet of 205 aircraft, including 182 jet passenger aircraft that have more than 100 seats and 12 jet freighters. The following table sets forth the details of our fleet as of December 31, 2006:

	Total Number of Aircraft	Number of Aircraft Owned and under Finance Lease	Aircraft under Operating Lease	Average Number of Seats	Average age (in years)(1)
Jet Passenger Aircraft:					
Wide-body:					
A340-600	5	5	—	322	3.6
A340-300	5	5	—	289	10.6
A330-300	7	—	7	300	0.9
A330-200	3	—	3	264	1.3
A300-600	9	9	—	269	14.2
B767-300	3	3	—	263	10.7
Narrow-body:					
MD-90	9	9	—	157	9.1
A321	6	6	—	185	2.0
A320	63	37	26	158	5.7
A319	13	3	10	122	5.0
Boeing 737-800	7	—	7	158	3.1
Boeing 737-700	29	14	15	122	3.6
Boeing 737-300	23	13	10	138	9.9
EMB 145	7	7	—	50	1.4
CRJ-200	5	5	—	50	5.4
Total Passenger Aircraft:	194	116	78	—	—
Cargo Aircraft:					
MD-11F	6	6	—	—	15
A300F	2	1	1	—	—
B747F	3	1	2	—	1
Total Fleet	205	124	81	—	—

(1) The average aircraft age is weighted by the number of available seats.

Our average daily aircraft utilization rate was 9.4 hours in 2006, which was approximately the same as in 2005. The table below sets forth the daily average utilization rates of our jet passenger aircraft for each of the three years ended December 31, 2006.

	2004	2005 (in hours)	2006
Wide-body:			
A340-600	12.6	13.8	14.0
A340-300	13.8	12.8	12.1
A330-300	—	—	9.3
A330-200	—	—	11.5
A300-600	8.8	8.9	8.6
A310	—	7.2	—

B767-300	—	9.2	9.1
Narrow-body:			
MD-90	8.5	8.0	8.1
MD-82	7.8	6.2	—
A321	6.4	8.3	9.0
A320	9.4	9.2	9.3
A319	9.5	9.5	7.8
Boeing 737-800	—	9.9	10.5
Boeing 737-700	9.9	9.9	9.9
Boeing 737-300	10.0	9.0	9.0
EMB 145	—	7.7	7.6
CRJ-200	—	5.1	7.4

Most of our jet passenger aircraft were manufactured by either Airbus or Boeing. Our Airbus A340-300 and A340-600 aircraft are primarily used for our routes to the United States, Europe, Hong Kong, Korea and other international destinations, including Los Angeles, New York, London, Paris, Seoul, and Bangkok, and on major domestic routes to cities such as Dalian. Our Airbus A330 aircraft are primarily used for the routes of Beijing-Shanghai and Shanghai-Hong Kong and Singapore, Australia, India, Japan and Korea routes. Our Airbus A320, MD-90 and Boeing B737 aircraft are suitable for middle and short distance flights and are primarily used for our domestic routes. Our EMB145 and CRJ-200 aircraft are mainly used on our regional short-distance routes.

Our MD-11F, A300F and B747F aircraft are used for our cargo operations and carry cargo to the United States, Europe and Japan. Our general aviation services customers include provincial authorities in charge of agriculture, forestry and geology.

Future Fleet Development. Our aircraft acquisition program focuses on aircraft that will modernize and rationalize our fleet to better meet the anticipated requirements of our route structure, taking into account aircraft size and fuel efficiency. Our aircraft acquisition program, however, is subject to the approval of the CAAC and the NDRC. The following table summarizes our currently anticipated jet aircraft deliveries from 2007 to 2008 as of December 31, 2006:

	2007	**2008**	**Total**
Aircraft			
A330-300	5	3	8
A330-200	1	1	2
A321	4	5	9
A320	2	8	10
A319	2	2	4
B737-800	0	1	1
B737-700	2	1	3
B787	0	4	4
EMB145	3	0	3
B747F	1	0	1
Total	20	25	45

The actual acquisition of any of these aircraft or any additional aircraft may depend on such factors as the general economic conditions, our operating results and other capital requirements. We believe that our aircraft acquisition plan will help us accomplish our expansion plans while maintaining an efficient fleet and ensuring alternative sources of supply.

Fleet Financing Arrangements. We generally acquire aircraft through either long-term capital leases or operating leases. To take advantage of the low interest rates for long-term loans in 2002, we also purchased a certain number of aircraft and financed them by borrowing long-term loans from banks in China. Under the terms of most capital leases, we generally are obligated to make lease payments that finance most of the purchase price of the aircraft over the lease term. Upon the expiration of the lease term, we must either purchase the aircraft at a specified price or pay any amount by which such price exceeds the proceeds from the disposition of the aircraft to third parties. Alternatively, some capital leases provide for ownership of the aircraft to pass to us upon satisfaction of the final lease payment. Under capital leases, aircraft are generally leased for approximately the whole of their estimated working life, and the leases are either non-cancelable or cancelable only on a payment of a major penalty by the lessee. As a result, we bear substantially all of the economic risks and rewards of ownership of the aircraft held under capital leases. Operating leases, however, are customarily cancelable by the lessee on short notice and without major penalty. Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases.

We intend to increase the use of operating leases to improve the flexibility of our operations. However, each decision on our financing alternatives will depend on an evaluation of the following factors:

· our aircraft requirements and anticipated future deliveries;

· capital structure and cash flow situation;

· prevailing interest rates; and

· other market conditions in effect at the time of any such acquisition or financing.

All of our payment obligations under current aircraft leases have been guaranteed by banks in China.

Operating Facilities

Our corporate headquarters, base maintenance center and other primary airport facilities in Shanghai, occupying an area of approximately 412,422 square meters of land, are located at Hongqiao Airport. We also own office buildings, cargo operating buildings and a maintenance center at Pudong International Airport. The total gross floor area of all of our buildings and facilities is approximately 341,000 square meters.

We own all of the buildings and facilities located at Hongqiao Airport, with the exception of the office buildings where our corporate headquarters are located. We lease from CEA Holding our corporate headquarters office buildings and the land on which our corporate headquarters are located. We have acquired buildings and ancillary facilities at Pudong International Airport with a total gross floor area of approximately 158,400 square meters.

We also have operations in the airports in Nanjing, Qingdao, Jinan, Taiyuan, Shijiazhuang, Hefei, Nanchang, Ningbo, Wuhan, Kunming and Xi'an, respectively. In Nanjing, we lease all the buildings and facilities our Company occupies from the airport authority. In Qingdao, Hefei and Nanchang, we have the right to use such buildings and facilities constructed and maintained by our Company. However, the right to use such buildings and facilities cannot be transferred or leased to third parties. In Taiyuan and Shijiazhuang, we own our maintenance facilities and lease office building from CEA Holding and other facilities from the local airport authorities. In Kunming and Xi'an, we leased from CEA Holding operating facilities including office buildings, warehouses and workshops under an agreement.

Item 4A. Unresolved Staff Comments

None.

Item 5. Operating and Financial Review and Prospects

You should read the following discussion in conjunction with our audited consolidated financial statements, together with the related notes, included elsewhere in this Annual Report. Our consolidated financial statements have been prepared in accordance with IFRS. For a discussion of certain differences between IFRS and U.S. GAAP as they relate to us, see Note 40 to our audited consolidated financial statements included in this Annual Report. The condensed consolidated financial statements, prepared in accordance with U.S. GAAP, are also presented in this Annual Report. We acquired from CEA Holding certain selected assets and liabilities relating to the aviation businesses of CEA Yunnan and CEA Northwest in June 2005. Our consolidated financial statements as of and for the year ended December 31, 2006 reflect the results of operations of those acquired assets and liabilities from the effective date of the acquisition, June 30, 2005. Under U.S. GAAP, the acquisitions would have been accounted for as a combination of entities under common control since our Company and the aviation businesses of CEA Yunnan and CEA Northwest were under the common control of CEA Holding. Under this method, the acquired assets and liabilities would have been accounted for at their historical cost under U.S. GAAP and the consolidated financial statements for all years presented would have been retroactively restated as if the acquired entities had always been part of our Company. This method is reflected in the significant differences between IFRS and U.S. GAAP provided in Note 40 to our audited consolidated financial statements included in this Annual Report. Our condensed consolidated financial statements prepared and presented in accordance with U.S. GAAP to reflect the effect of the acquisitions of certain selected assets and liabilities of CEA Yunnan's and CEA Northwest's aviation businesses under common control for the relevant periods are also set forth in Note 41 to our audited consolidated financial statements included in this Annual Report.

Overview

Our primary business is the provision of domestic, Hong Kong regional and international passenger and cargo airline services. Our overall capacity on an available tonne kilometer, or ATK, basis increased by 26.4%, from 8,751.5 million ATKs in 2005 to 11,065.6 ATKs in 2006, and our passenger capacity on an available seat kilometer, or ASK, basis increase by 34.4%, from 52,427.9 million ASKs in 2005 to 70,468.3 million ASKs in 2006. Total traffic on a revenue tonne kilometer, or RTK, basis increase by 28.5%, from 5,395.2 million RTKs in 2005 to 6,931.0 PTKs in 2006.

In addition to our acquisition from CEA Holding of certain selected assets and liabilities relating to the aviation businesses of CEA Yunnan and CEA Northwest in June 2005, we increased our equity interest in CEA Wuhan from 40% to 96% through an acquisition of interest held by other shareholders of CEA Wuhan early 2006. See the section headed "Item 4. Information on the Company — History and Development of the Company" for more details. Those acquisitions have resulted in the expansion of our operation and increase in our traffic revenue. For example, the operations in connection with the certain selected assets and liabilities we acquired relating to the aviation businesses of CEA Yunnan and CEA Northwest contributed revenues of RMB8,799 million to our Company in 2006 and had a material impact on our overall results of operation for the year ended December 31, 2006. With the integration of those acquired assets or entities with our existing operations, we expect to achieve an improvement of our service quality and enhancement of our overall strength and market competitiveness by rationalizing our route network and fleet, centralizing our procurement of aircraft and aircraft components, integrating our maintenance resources as well as streamlining our sales channels.

As required under IFRS, we applied the acquisition accounting method to account for the acquisitions of certain selected assets and liabilities relating to the aviation businesses of CEA Yunnan and CEA Northwest. Under U.S. GAAP, such transactions are considered "combinations of entities under common control" since our Company and the aviation businesses of CEA Yunnan and CEA Northwest were under the common control of CEA Holding. Such transactions are accounted for in a manner similar to "pooling-of-interests", retroactively restating all years presented on a combined basis as if the acquisitions had been in effect since inception, whereby related assets and liabilities of the aviation businesses would be accounted for at historical cost and the related results of operations would be included in the consolidated financial statements for the earliest year presented.

The historical results of operations discussed in this Annual Report may not be indicative of our future operating performance. Like those of other airlines, our operations substantially depend on overall passenger and cargo traffic volume and are subject to seasonal and other variations that may influence passenger travel demand and cargo volume and may not be under our control, including unusual political events and other unforeseen events. Our operations will be affected by, among other things, fluctuations in the aviation fuel price, aircraft acquisition and leasing costs, maintenance expenses, take-off and landing charges, wages, salaries and benefits, other operating expenses and the rates of income taxes paid. We expect the aviation fuel price to continue to remain high and have a material adverse effect on our profitability. We expect depreciation expenses and operating lease expenses to increase as new aircraft and related flight equipment are acquired. Maintenance expenses may also increase as a result of acquisitions of new aircraft, although we expect to benefit from certain maintenance and fuel cost savings as older aircraft are retired and replaced.

Our financial performance is also significantly affected by factors associated with operating in a highly regulated industry, as well as a number of other external variables, including political and economic conditions in China, competition, foreign exchange fluctuations and public perceptions of the safety of air travel with Chinese airlines. Because nearly every aspect of our airline operations is subject to the regulation of the CAAC, our operating revenues and expenses are directly affected by the CAAC regulations with respect to, among other things, domestic airfares, level of commissions paid to sales agents, the aviation fuel price, take-off and landing charges and route allocations. The nature and extent of airline competition and the ability of Chinese airlines to expand are also significantly affected by various CAAC regulations and policies. Changes in the CAAC's regulatory policies, or in the implementation of such policies, are therefore likely to have a significant impact on our future operations.

Certain Financial Information by Business Segment

For the year ended December 31, 2005, we principally operated in one business segment, namely the operation of our civil aviation business, including the provision of passenger, cargo, mail delivery and other extended transportation services. In view of the continued growth of our China cargo and logistics transportation services, we began to review the cargo and logistic transportation services business separately and to report it as a separate segment. Accordingly, from 2006, our Company operates in two business segments, namely the passenger business segment (including cargo carried by passenger flights) and cargo and logistics transportation business segment.

The following table sets forth our segment results for the year ended December 31, 2006:

	Passenger RMB	Cargo and logistics RMB	Unallocated RMB	Total RMB
		(in millions)		
Traffic revenues	33,490	2,843	—	36,333
Other revenues and operating income	1,066	709	141	1,916
Total segment revenue	34,556	3,552	141	38,249
Inter-segment revenue	(760)	—	—	(760)
Revenues	33,796	3,552	141	37,489
Operating (loss)/profit - segment results	(2,771)	(242)	22	(2,991)
Interest income	112	6	2	120
Finance costs	(777)	(93)	(8)	(878)
Share of results of associates	104	—	—	104
Share of results of jointly controlled entities	30	—	—	30
(Loss)/profit before income tax	(3,302)	(329)	16	(3,615)
Income tax	198	(30)	(5)	163
(Loss)/profit for the year	(3,104)	(359)	11	(3,452)

The following table sets forth our segment results for the year ended December 31, 2005:

	Passenger RMB	Cargo and logistics RMB	Unallocated RMB	Total RMB
		(in millions)		
Traffic revenues	23,182	2,732	—	25,914
Other revenues and operating income	1,012	575	98	1,685
Total segment revenue	24,194	3,307	98	27,599

Inter-segment revenue	(144) &#1