CHINA SOUTHERN AIRLINES CO LTD
Form 20-F
June 23, 2008

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 20-F

(Mark One)

o **REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (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, 2007

OR

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

OR

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

Date of event requiring this shell company report _____________
For the transition period from _________ to

Commission file number 1-14660

(Exact name of Registrant as specified in its charter)

CHINA SOUTHERN AIRLINES COMPANY LIMITED

(Translation of Registrant's name into English)

THE PEOPLE'S REPUBLIC OF CHINA

(Jurisdiction of incorporation or organization)

278 JI CHANG ROAD
GUANGZHOU

PEOPLE'S REPUBLIC OF CHINA, 510405

(Address of principal executive offices)

Mr. Xie Bing, 02086124462,
webmaster@csair.com and/or 02086659040
278 JI CHANG ROAD
GUANGZHOU
PEOPLE'S REPUBLIC OF CHINA, 510405

(Name, Telephone, E-mail and/or Facsimile number and Address of Company Contact Person)

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
Ordinary H Shares of par value RMB1.00 per share represented by American Depositary Receipts	*New York Stock Exchange, Inc.*

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

None

(Title of Class)

(Title of Class)

SEC 1852 (05-06) **Persons who respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB control number.**

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. 2,200,000,000 ordinary Domestic Shares of par value RMB1.00 per share and 1,174,178,000 ordinary H Shares of par value RMB1.00 per share and 1,000,000,000 ordinary A Shares of par value RMB1.00 per share were issued and outstanding as of December 31, 2007.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

o Yes þ No

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.

o Yes þ No

Note — Checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from their obligations under those Sections.

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.

þ Yes oNo

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. (Check one):

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

U.S. GAAP o	International Financial Reporting Standards þ as issued by the International Accounting Standards Board	Other o

If "Other" has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow.

o Item 17 o Item 18

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).

oYes þ No

TABLE OF CONTENTS
China Southern Airlines Company Limited

FORWARD-LOOKING STATEMENTS

This Annual Report contains forward-looking statements. These statements appear in a number of different places in this Annual Report. A forward-looking statement is usually identified by the use in this Annual Report of certain terminology such as “estimates”, “projects”, “expects”, “intends”, “believes”, “plans”, “anticipates”, or their negatives o comparable words. Also look for discussions of strategy that involve risks and uncertainties. Forward-looking statements include statements regarding the outlook for the Company’s future operations, forecasts of future costs and expenditures, evaluation of market conditions, the outcome of legal proceedings (if any), the adequacy of reserves, or other business plans. You are cautioned that such forward-looking statements are not guarantees and involve risks, assumptions and uncertainties. The Company’s actual results may differ materially from those in the forward-looking statements due to risks facing the Company or due to actual facts differing from the assumptions underlying those forward-looking statements.

Some of these risks and assumptions, in addition to those identified under Item 3, “Key Information - Risk Factors,” include:

- general economic and business conditions, including changes in interest rates;
- prices and other economic conditions;
- natural phenomena;
- actions by government authorities, including changes in government regulations;
- the Company’s relationship with CSAHC;
- uncertainties associated with legal proceedings;
- technological development;
- future decisions by management in response to changing conditions;
- the Company’s ability to execute prospective business plans; and
- misjudgments in the course of preparing forward-looking statements.

The Company advises you that these cautionary remarks expressly qualify in their entirety all forward-looking statements attributable to the Company, the Group and persons acting on their behalf.

INTRODUCTORY NOTE

In this Annual Report, unless the context indicates otherwise, the “Company” means China Southern Airlines Company Limited, a joint stock company incorporated in China on March 25, 1995, the “Group” means the Company and its consolidated subsidiaries, and “CSAHC” means China Southern Air Holding Company, the Company’s parent company which holds a 50.3% controlling interest in the Company.

References to “China” or the “PRC” are to the People’s Republic of China, excluding Hong Kong, Macau and Taiwan. References to “Renminbi” or “RMB” are to the currency of China, references to “U.S. dollars”, “$” or “US$” are to the curren of the United States of America (the “U.S.” or “United States”), and reference to “HK$” is to the currency of Hong Kong. Reference to the “Chinese Government” is to the national government of China. References to “Hong Kong” or “Hong

Kong SAR" are to the Hong Kong Special Administrative Region of the People's Republic of China. References to "Macau" or "Macau SAR" are to the Macau Special Administrative Region of the People's Republic of China.

The Company presents its consolidated financial statements in Renminbi. The consolidated financial statements of the Company for the year ended December 31, 2007 (the "Financial Statements") have been prepared in accordance with all applicable International Financial Reporting Standards ("IFRSs"), which collective term includes all applicable individual International Financial Reporting Standards, International Accounting Standards ("IASs") and interpretations issued by the International Accounting Standard Board (the "IASB").

1

Solely for the convenience of the readers, this Annual Report contains translations of certain Renminbi amounts into U.S. dollars at the rate of US$1.00 = RMB7.3046, which is the average of the buying and selling rates as quoted by the People's Bank of China at the close of business on December 31, 2007. No representation is made that the Renminbi amounts or U.S. dollar amounts included in this Annual Report could have been or could be converted into U.S. dollars or Renminbi, as the case may be, at any particular rate or at all. Any discrepancies in the tables included herein between the amounts listed and the totals are due to rounding.

GLOSSARY OF AIRLINE INDUSTRY TERMS

In this Annual Report, unless the context indicates otherwise, the following terms shall have the respective meanings set forth below.

Capacity Measurements

"available seat kilometers" or "ASKs"	the number of seats made available for sale multiplied by the kilometers flown
"available ton kilometers" or "ATKs"	the number of tons of capacity available for the transportation of revenue load (passengers and cargo) multiplied by the kilometers flown

Traffic Measurements

"revenue passenger kilometers" or "RPKs"	the number of revenue passengers carried multiplied by the kilometers flown
"cargo ton kilometers"	the cargo load in tons multiplied by the kilometers flown
"revenue ton kilometers" or "RTKs"	the load (passenger and cargo) in tons multiplied by the kilometers flown

Yield Measurements

"passenger yield"	revenue from passenger operations divided by RPKs
"cargo yield"	revenue from cargo operations divided by cargo ton kilometers
"average yield"	revenue from airline operations (passenger and cargo) divided by RTKs
"ton"	a metric ton, equivalent to 2,204.6 pounds

Load Factors

"passenger load factor"	RPKs expressed as a percentage of ASKs

“overall load factor”	RTKs expressed as a percentage of ATKs
“breakeven load factor”	the load factor required to equate scheduled traffic revenue with operating costs assuming that total operating surplus is attributable to scheduled traffic operations

Utilization

“utilization rate”	the actual number of flight hours per aircraft per operating day

Equipment

"rotables"	aircraft parts that are ordinarily repaired and reused
"expendables"	aircraft parts that are ordinarily used up and replaced with new parts

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.

Selected Financial Data

The following tables present selected financial data of the Company as of and for each of the years in the five-year period ended December 31, 2007. The selected consolidated statement of operations data for each of the years in the three-year period ended December 31, 2007 and selected consolidated balance sheet data as of December 31, 2007 and 2006, have been derived from the consolidated financial statements of the Company, including the related notes, included elsewhere in this Annual Report. The selected consolidated statement of operations data for the years ended December 31, 2003 and 2004 and selected consolidated balance sheet data as of December 31, 2005, 2004 and 2003 are derived from the Company's audited consolidated financial statements that are not included in this Annual Report.

Moreover, the selected financial data should be read in conjunction with our consolidated financial statements together with accompanying notes and "Item 5. Operating and Financial Review and Prospects" included elsewhere in this Annual Report. Unless otherwise indicated, our consolidated financial statements are prepared and presented in accordance with International Financial Reporting Standards, or IFRSs.

	Year ended December 31,					
	2007 US$	**2007 RMB**	**2006 RMB**	**2005 RMB**	**2004 RMB**	**2003 RMB**
Consolidated Statement of Operations Data:	**(in million, except per share data)**					
Operating revenue	7,461	54,502	46,219	38,293	23,974	17,470
Operating expenses	(7,256)	(53,013)	(45,907)	(39,598)	(23,065)	(17,014)
Operating profit/(loss)	223	1,619	645	(1,337)	908	434
Profit/(loss) before taxation	400	2,923	357	(1,853)	220	(511)
Profit/(loss) for the year	283	2,065	204	(1,846)	155	(187)
Profit/(loss) attributable to :						
	256	1,871	188	(1,848)	(48)	(358)

Equity shareholders of the Company						
Minority interests	27	194	16	2	203	171
Basic and diluted earnings/(loss) per share	0.06	0.43	0.04	(0.42)	(0.01)	(0.09)
Basic and diluted earnings/(loss) per ADR	2.93	21.39	2.15	(21.12)	(0.55)	(4.68)
Cash dividends declared per share	—	—	—	—	—	—

Consolidated Balance Sheet Data:	As of December 31, 2007 US$	2007 RMB	2006 RMB	2005 RMB	2004 RMB	2003 RMB
	(in million)					
Cash and cash equivalents	524	3,824	2,264	2,901	3,083	2,080
Other current assets	680	4,966	4,419	4,320	4,286	1,922
Property, plant and equipment, net	8,001	58,441	56,335	54,254	46,841	28,536
Total assets	11,217	81,933	75,584	71,402	62,383	39,062
Bank and other loans, including long-term bank and other loans due within one year	3,415	24,948	23,822	16,223	11,518	7,097
Obligations under finance leases due within one year	394	2,877	3,091	3,373	2,144	1,298
Bank and other loans, excluding balance due within one year	1,242	9,074	10,018	12,740	11,935	4,522
Obligations under finance leases, excluding balance due within one year	1,760	12,858	12,307	12,459	9,599	5,543
Total equity	2,014	14,712	12,121	11,936	13,903	13,569

Selected Operating Data

The following selected operating data of the Group for the five years ended December 31, 2007 have been derived from consolidated financial statements prepared in accordance with IFRSs and other data provided by the Group which have not been audited.

The operating data and the profit analysis and comparison for other years below is calculated and disclosed in accordance with the statistical standards, which have been implemented since January 1, 2001. See “Glossary of Airline Industry Terms” at the front of this Annual Report for definitions of certain terms used herein.

	Year ended December 31,				
Capacity	**2007**	**2006**	**2005**	**2004**	**2003**
ASK (million)	109,733	97,059	88,361	53,769	40,867
ATK (million)	14,208	12,656	11,509	7,446	5,921
Kilometers flown (thousand)	675,127	594,957	539,844	324,827	249,068
Hours flown (thousand)	1,075	931	846	501	385
Number of landing and take-offs	543,789	481,810	438,674	274,580	214,190
Traffic					
RPK (million)	81,727	69,582	61,923	37,196	26,387
RTK (million)	9,250	8,071	7,284	4,663	3,561
Passengers carried (thousand)	56,903	49,206	44,119	28,207	20,470
Cargo and mail carried (tons)	872,000	819,000	775,000	545,000	464,000
Load Factors					
Passenger load factor (RPK/ASK) (%)	74.5	71.7	70.1	69.2	64.6
Overall load factor (RTK/ATK) (%)	65.1	63.8	63.3	62.6	60.1
Breakeven load factor (%)	64.8	64.9	67.0	61.9	61.6
Yield					
Yield per RPK (RMB)	0.61	0.60	0.55	0.57	0.57
Yield per cargo and mail ton kilometers (RMB)	1.87	1.89	1.75	1.67	1.62
Yield per RTK (RMB)	5.76	5.59	5.14	5.01	4.76
Fleet					
— Boeing	177	159	140	137	108
— Airbus	119	103	71	46	24
— McDonnell Douglas	25	36	36	35	—
— Others	11	11	14	13	—
Total aircraft in service at period end	332	309	261	231	132
Overall utilization rate (hours per day)	9.4	9.5	9.6	9.9	8.5
Financial					
Operating cost per ATK (RMB)	3.73	3.63	3.44	3.10	2.87

Exchange Rate Information

The following table sets forth certain information concerning exchange rates, based on the noon buying rates in New York City for cable transfers in foreign currencies, as certified for customs purposes by the Federal Reserve Bank of New York (the “Noon Buying Rate”), between Renminbi and U.S. dollars for the five most recent financial years.

Period	Period End	Average(1) (RMB per US$)	High	Low
Annual Exchange Rate				
2003	8.2767	8.2772	8.2800	8.2769
2004	8.2765	8.2765	8.2889	8.2641
2005	8.0694	8.1825	8.2767	8.0702
2006	7.8041	7.9723	8.0702	7.8041
2007	7.2946	7.6058	7.8127	7.2946

(1) Determined by averaging the rates on the last business day of each month during the relevant period.

The following table sets out the range of high and low exchange rates, based on the Noon Buying Rate, between Renminbi and U.S. dollars, for the following periods.

Period	High	Low
Monthly Exchange Rate		
December 2007	7.4120	7.2946
January 2008	7.2946	7.1818
February 2008	7.1973	7.1100
March 2008	7.1110	7.0105
April 2008	7.0185	6.9840
May 2008	7.0000	6.9377
June 2008 (up to June 19, 2008)	6.9633	6.8770

Dividend Payments

No interim dividends were paid during the year ended December 31, 2007. The Board of Directors of the Company (“Board of Directors”) did not recommended payment of a final dividend in respect of the year ended December 31, 2007.

Capitalization and Indebtedness

Not applicable.

Reasons for the Offer and Use of Proceeds

Not applicable.

Risk Factors

Risks Relating to the Company

Government ownership and control of the Company

Major Chinese airlines are wholly- or majority-owned either by the Chinese Government or by provincial or municipal governments in China. CSAHC, an entity wholly-owned by the Chinese Government, holds and exercises the rights of ownership of all of the Domestic Shares or 50.3% of the equity of the Company. The interests of the Chinese Government in the Company and in other Chinese airlines may conflict with the interests of the holders of the ADRs, H Shares and A Shares. The public policy considerations of the Chinese Government in regulating the Chinese commercial aviation industry may also conflict with its indirect ownership interest in the Company.

High operating leverage and foreign exchange exposure

The airline industry is generally characterized by a high degree of operating leverage. In addition, due to high fixed costs, the expenses relating to the operation of any flight do not vary proportionately with the number of passengers carried, while revenues generated from a flight are directly related to the number of passengers carried and the fare structure of such flight. Accordingly, a decrease in revenues could result in a proportionately higher decrease in net income. Moreover, as the Group has substantial obligations denominated in foreign currencies, its results of operations are significantly affected by fluctuations in foreign exchange rates, particularly for the U.S. dollar and the Japanese yen. The Company incurred a net exchange gain of RMB1,492 million and RMB2,832 million for 2006 and 2007, respectively, mainly as a result of Reminbi appreciation. A majority of this exchange gain was unrealized in nature.

Liquidity

As of December 31, 2007, the Group had net current liabilities position of RMB33,811 million which was due to the use of short-term bank loans for the aircraft acquisitions and other capital expenditures. The Group's short-term bank loans amounted to RMB24,948 million as at December 31, 2007. In 2008 and thereafter, the liquidity of the Group is primarily dependent on its ability to maintain adequate cash inflows from operations to meet its debt obligations as they fall due, the renewal of its short-term bank loans and on its ability to obtain adequate external financing to meet its committed future capital expenditures. The Group may not be able to meet its debt obligations as they fall due and committed future capital expenditures if certain assumptions about the operations and the availability of external financing on acceptable terms are inaccurate.

The Group has obtained firm commitments from its principal bankers to renew its short-term bank loans outstanding as of December 31, 2007 when they fall due during 2008. Subsequent to December 31, 2007 through March 31, 2008, the Group renewed short-term bank loans outstanding of RMB3,179 million. The directors of the Company believe that sufficient financing will be available to the Group, however there can be no assurance that such loan financing will be available on terms acceptable to the Group.

Potential conflicts of interest

CSAHC will continue to be the controlling shareholder of the Company. CSAHC and certain of its associates will continue to provide certain important services to the Company, including the import and export of aircraft spare parts and other flight equipment, advertising services, provision of air catering , pilot training services, air ticket selling services, cleaning services, property management services, leasing of properties and financial services. In addition, Mr. Liu Shao Yong, the Chairman of the Board of Directors, also serves as the General Manager of CSAHC. The interests of CSAHC may conflict with those of the Company. In addition, any disruption of the provision of services by CSAHC's associates or a default by CSAHC of its obligations owed to the Company could affect the Company's operations and financial conditions. In particular, as part of its cash management system, the Company periodically places significant amount of demand deposits with China Southern Airlines Group Finance Company Limited ("SA Finance"), a PRC authorized financial institution controlled by CSAHC and an associate of the Company. As a result, the Company's deposits with SA Finance are subject to the risks associated with the business of SA Finance over which the Company does not exercise control. As of December 31, 2006 and 2007, the Group had short-term deposits of RMB629 million and RMB906 million, respectively, with SA Finance.

Certain transactions between the Company and CSAHC or its associates (as defined in the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited (the "Hong Kong Listing Rules")) will constitute connected transactions of the Company under the Hong Kong Listing Rules and, unless exemptions are applicable or waivers are granted, will be subject to disclosure requirements and/or independent shareholders' approval in a general meeting.

General Economic and Business conditions and natural phenomena

The US subprime crisis meltdown is an ongoing economic problem manifesting itself through liquidity issues in the global banking system owing to foreclosures which accelerated in the United States in late 2006 and has an adverse impact on global economy in 2007 and 2008. The financial crisis and other global events may reduce consumer spending or cause shifts in spending. A general reduction or shift in discretionary spending could result in decreased demand for leisure and business travel and can also impact the Company's ability to raise fares to counteract increased fuel and labor costs.

The US subprime crisis added to the global economic slowdown which may also affect the growth of the Chinese economy. Chinese macroeconomic controls such as financing adjustments, credit adjustments, price controls and exchange rate policies will also affect the Chinese economic condition. This domestic economic condition and the increase of jet fuel prices will also affect the development of the aviation industry.

In 2008, a number of large-scale natural disasters occurred in China, such as the southern China snow storms in January and the May 12 earthquake in Sichuan province. Disasters such as these can affect the airline industry and the Company by reducing revenues and impacting travel behavior.

In summary, both international and domestic economic fluctuations and Chinese macroeconomic controls affect the demand for air travel. Additionally, increasingly strict security measures make air travel a hassle in the eyes of some consumers. These factors can have an uncertain impact on the development of the aviation industry.

Risks relating to certain real property

Although systems for registration and transfer of land use rights and related real property interests in China have been implemented, such systems do not yet comprehensively account for all land and related property interests. The land in Guangzhou on which the Company's headquarters and other facilities are located and the buildings that the Company uses at its route bases in Wuhan and Haikou are leased by the Company from CSAHC. However, CSAHC lacks adequate documentation evidencing CSAHC's rights to such land and buildings, and, as a consequence, the lease agreements between CSAHC and the Company for such land have not been registered with the relevant authorities. As a result, such lease agreements may not be enforceable. Lack of adequate documentation for land use rights and ownership of buildings subjects the Company to challenges and claims by third parties with respect to the Company's use of such land and buildings.

The Company has been occupying all of the land and buildings described above without challenge or claim by third parties. CSAHC has received written assurance from the General Administration of Civil Aviation of China ("CAAC") to the effect that CSAHC is entitled to continued use and occupancy of the land and certain related buildings and facilities. However, such assurance does not constitute formal evidence of CSAHC's right to occupy such lands, buildings and facilities or the right to transfer, mortgage or lease such real property interests. The Company cannot predict the magnitude of the adverse effect on its operations if its use of any one or more of these parcels of land or buildings were successfully challenged. CSAHC has agreed to indemnify the Company and Guangzhou Aircraft Maintenance Engineering Company Limited ("GAMECO"), the Company's jointly controlled entity, against any loss or damage caused by any challenge of, or interference with, the use by the Company and GAMECO of any of their respective land and buildings.

Risks associated with Hong Kong and Macau routes

The Company's Hong Kong regional routes benefit from traffic originating in Taiwan. Apart from temporary lifts of the ban on direct flights between Taiwan and Mainland China during the Lunar Chinese New Year and the Mid-Autumn Festival, travelers between Taiwan and China have had to make use of intermediate stops in Hong Kong or elsewhere. In such event, Xiamen Airlines Company Limited ("Xiamen Airlines"), the Company's subsidiary, might apply for route rights for direct flights between Taiwan and Mainland China, due partly to the proximity to Taiwan of Fujian province, where Xiamen Airlines is based. However, there can be no assurance that sufficient routes and flights between destinations in Taiwan and Mainland China could be obtained by Xiamen Airlines, if at all, or that adequate yields will be generated on these routes and flights.

Terrorist attacks or the fear of such attacks, even if not made directly on the airline industry, could negatively affect the Company and the airline industry. The travel industry continues to face on-going security concerns and cost burdens.

The aviation industry as a whole has been beset with high-profile terrorist attacks, most notably on September 11, 2001 in the United States. The issue could also affect China. Notably, on March 7, 2008, on a China Southern Airlines flight boarding in Urumqi, crew members discovered a suspected terrorist. Thereafter, the CAAC implemented increased security measures. Additional terrorist attacks, even if not made directly on the airline industry, or the fear of or the precautions taken in anticipation of such attacks (including elevated threat warnings or selective cancellation or redirection of flights) could materially and adversely affect the Company and the airline industry. Among possible effects that the Company could experience from terrorist attacks are substantial flight disruption costs caused by grounding of fleet, significant increase of security costs and associated passenger inconvenience, increased insurance costs, substantially higher ticket refunds and significantly decreased traffic and revenue per revenue passenger mile.

Risks associated with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 to evaluate internal controls over financial reporting

The United States Securities and Exchange Commission, or the SEC, as required by Section 404 of the Sarbanes-Oxley Act of 2002, adopted rules requiring every public company in the United States to include a management report on such company's internal control over financial reporting in its annual report, which contains management's assessment of the effectiveness of the company's internal control over financial reporting. In addition, the Company's independent registered public accounting firm is required to report on the effectiveness of the Company's internal control over financial reporting. Our independent registered public accounting firm may not be satisfied with our internal controls, the level at which our controls are documented, designed, operated and reviewed, or our independent registered public accounting firm may interpret the requirements, rules and regulations differently from us, then it may conclude that our internal control over financial reporting are not effective. Although our management concluded that our internal control over financial reporting as of December 31, 2007 was effective, we may discover other deficiencies in the course of our future evaluation of our internal control over our financial reporting and may be unable to remediate such deficiencies in a timely manner. If we fail to maintain the adequacy of our internal control over financial reporting, we may not be able to conclude that we have effective internal control over financial reporting on an ongoing basis, in accordance with the Sarbanes-Oxley Act. Moreover, effective internal control is necessary for us to produce reliable financial reports and is important to prevent fraud. As a result, our failure to achieve and maintain effective internal control over financial reporting could result in the loss of investor confidence in the reliability of our financial statements, which in turn could harm our business and negatively impact the trading prices of our ADRs, H Shares or A Shares.

Passive Foreign Investment Company

Depending upon the value of our shares and ADRs and the nature of our assets and income over time, we could be classified as a passive foreign investment company, or PFIC, by the United States Internal Revenue Service, or IRS, for U.S. federal income tax purposes. The Company believes that it was not a PFIC for the taxable year 2007. However, there can be no assurance that the Company will not be a PFIC for the taxable year 2008 and/or later taxable years, as PFIC status is re-tested each year and depends on the facts in such year.

The Company will be classified as a PFIC in any taxable year if either: (1) the average percentage value of its gross assets during the taxable year that produce passive income or are held for the production of passive income is at least 50% of the value of its total gross assets or (2) 75% or more of its gross income for the taxable year is passive income (such as certain dividends, interest or royalties). For purposes of the first test: (1) any cash, cash equivalents, and cash invested in short-term, interest bearing, debt instruments, or bank deposits that is readily convertible into cash, will generally count as producing passive income or held for the production of passive income and (2) the average value of the Company's gross assets is calculated based on its market capitalization.

If the Company were a PFIC, you would generally be subject to additional taxes and interest charges on certain "excess" distributions the Company makes and on any gain realized on the disposition or deemed disposition of your ADRs, regardless of whether the Company continues to be a PFIC in the year in which you receive an "excess" distribution or dispose of or are deemed to dispose of your ADRs. Distributions in respect of your ADRs during a taxable year would generally constitute "excess" distributions if, in the aggregate, they exceed 125% of the average amount of distributions in respect of your ADRs over the three preceding taxable years or, if shorter, the portion of your holding period before such taxable year. For more information on the United States federal income tax consequences to you that would result from our classification as a PFIC, please see Item 10, "Taxation — United States Federal Income Taxation — U.S. Holders — Passive Foreign Investment Company".

Risks Relating to the Chinese Commercial Aviation Industry

Government regulation

The Company's ability to implement its business strategy will continue to be affected by regulations and policies issued or implemented by the CAAC, which encompasses substantially all aspects of the Chinese commercial aviation industry, including the approval of domestic, Hong Kong regional and international route allocation, air fares, aircraft acquisition, jet fuel prices and standards for aircraft maintenance, airport operations and air traffic control. Such regulations and policies limit the flexibility of the Company to respond to market conditions, competition or changes in the Company's cost structure. The implementation of specific CAAC policies could from time to time adversely affect the Company's operations. The CAAC has confirmed in writing that the Company will be treated equally with other Chinese airlines with respect to certain matters regulated by the CAAC. Nevertheless, there can be no assurance that the CAAC will, in all circumstances, apply its regulations and policies in a manner that results in equal treatment of all airlines.

Jet fuel supply and costs

The availability and cost of jet fuel have a significant impact on the Group's results of operations. The Group's jet fuel costs for 2007 accounted for 62.98% of its flight operations expenses. All of the domestic jet fuel requirements of Chinese airlines (other than at the Shenzhen, Zhuhai and Sanya airports) must be purchased from the exclusive providers, China Aviation Oil Supplies Company ("CAOSC") and Bluesky Oil Supplies Company, companies controlled and supervised by the CAAC. Chinese airlines may also purchase their jet fuel requirements at the Shenzhen, Zhuhai and Sanya airports from joint ventures in which the CAOSC is a partner. Jet fuel obtained from the CAOSC's regional branches is purchased at uniform prices throughout China that are determined and adjusted by the CAOSC from time to time with the approval of the CAAC and the pricing department of the State Planning Commission based on market conditions and other factors. As a result, the costs of transportation and storage of jet fuel in all regions of China are spread among all domestic airlines.

Prior to 1994, domestic jet fuel prices were generally below international jet fuel prices. From 1994 to 2006, however, CAOSC's domestic jet fuel prices were above international jet fuel prices, sometimes creating tensions over the fuel supply. In 2007, the domestic price of jet fuel from CAOSC was below international jet fuel prices. However, given the rapid increase and constant fluctuation in world oil prices, there is no way to assure that domestic prices for jet fuel do not fluctuate as well.

In addition, jet fuel shortages have occurred in China and, on some rare occasions prior to 1993, required the Company to delay or even cancel flights. Although such shortages have not materially affected the Company's operations since 1993, there can be no assurance that such a shortage will not occur in the future. If such a shortage occurs in the future and the Company is forced to delay or cancel flights due to fuel shortage, its operational reputation among passengers as well as its operations may suffer.

A change in annual average price of US$1 per tonne of jet fuel affects the Group's annual fuel costs by approximately RMB22 million, assuming no change in volume of fuel consumed. Accordingly, even if the jet fuel supply remains uninterrupted, increases in jet fuel prices will nevertheless adversely impact our financial results.

Infrastructure limitations

The rapid increase in air traffic volume in China in recent years has put pressure on many components of the Chinese commercial aviation industry, including China's air traffic control system, the availability of qualified flight personnel and airport facilities. Airlines, such as the Company, which have route networks that emphasize short- to medium-haul routes, are generally more affected by insufficient aviation infrastructure in terms of on-time performance and high operating costs due to fuel inefficiencies resulting from the relatively short segments flown, as well as the relatively high proportion of time on the ground during turnaround. All of these factors may adversely affect the perception of the service provided by an airline and, consequently, the airline's operating results. In recent years, the CAAC has placed increasing emphasis on the safety of Chinese airline operations and has implemented measures aimed at improving the safety record of the industry. The ability of the Company to increase utilization rates and to provide safe and efficient air transportation in the future will depend in part on factors such as the improvement of national air traffic control and navigation systems and ground control operations at Chinese airports, factors which are beyond the control of the Company.

Competition

The CAAC's extensive regulation of the Chinese commercial aviation industry has had the effect of managing competition among Chinese airlines. Nevertheless, competition has become increasingly intense in recent years due to a number of factors, including relaxation of certain regulations by the CAAC and an increase in the capacity, routes and flights of Chinese airlines. Competition in the Chinese commercial aviation industry has led to widespread price-cutting practices that do not in all respects comply with applicable regulations. Until the interpretation of CAAC regulations limiting such price-cutting has been finalized and strictly enforced, discounted tickets from competitors will continue to have an adverse effect on the Company's sales.

The Company faces varying degrees of competition on its Hong Kong and Macau regional routes from certain Chinese airlines and Cathay Pacific Airways, Dragonair and Air Macau, and on its international routes, primarily from non-Chinese airlines, most of which have significantly longer operating histories, substantially greater financial and technological resources and greater name recognition than the Company. In addition, the public's perception of the safety and service records of Chinese airlines could adversely affect the Company's ability to compete against its Hong Kong regional and international competitors. Many of the Company's international competitors have larger sales networks and participate in reservation systems that are more comprehensive and convenient than those of the Company, or engage in promotional activities, that may enhance their ability to attract international passengers.

Limitation on foreign ownership

Chinese Government policies limit foreign ownership in Chinese airlines. Under these policies, the percentage ownership of the Company's total outstanding ordinary shares held by investors in Hong Kong and any country outside China ("Foreign Investors") may not in the aggregate exceed 49%. Currently, 26.8% of the total outstanding ordinary shares of the Company are held by Foreign Investors. For so long as the limitation on foreign ownership is in force, the Company will have no meaningful access to the international equity capital markets.

Risks relating to the PRC

Foreign exchange risks

Under current Chinese foreign exchange regulations, Renminbi is fully convertible for current account transactions, but is not freely convertible for capital account transactions. All foreign exchange transactions involving Renminbi must take place either through the People's Bank of China ("PBOC") or other institutions authorized to buy and sell foreign exchange or at a swap centre.

The Group has significant exposure to foreign currency risk as sub