Interview with Chief Executive Officer

Andrew Brandler,
Chief Executive Officer,
CLP Holdings
(AB)

An open dialogue with stakeholders enhances understanding of CLP's activities. We asked a fund manager, a banker, an investment analyst and a shareholder to put their questions to Andrew Brandler, Chief Executive Officer.

Joanne Wong,
Research Analyst,
Franklin Templeton Investments
(JW)

JW: While it is too early to predict what the regulatory environment for the Hong Kong electricity industry will be like after 2008, can you discuss your views on the various options available, including open market competition, interconnection with Guangdong, Consumer Price Index (CPI) minus X regime or merger between CLP and Hongkong Electric?

AB: The achievements of the SoC in promoting a world-class electricity supply at reasonable prices to Hong Kong consumers for nearly 40 years should be recognised and not lightly set aside. Experience elsewhere in the world highlights the risks of radical and ill-conceived regulatory change. Change in the electricity industry tends to be irreversible – you can never restore the previous regulatory framework once it has been dismantled – the problem becomes to correct the mistakes and shortcomings of the new regime.

You mentioned several options available for a post-2008 scenario. All of these have featured in the developing debate on the future of Hong Kong's electricity industry – but none of these seems viable at this stage. Let me explain further.

Open market competition is not an option, because genuine and meaningful competition needs multiple competitors in the industry. To do that, Hong Kong would need to introduce electricity producers in Guangdong Province to the Hong Kong market. However, Guangdong is suffering from a significant shortage of electricity. During 2002 alone, more than 7% of our electricity sales was to Guangdong. Even then, power shortages and electricity cuts have been affecting Guangdong's consumers. Bear in mind also the substantial increase in electricity demand in Guangdong (35% increase between 1999 and 2001 alone), the long lead time for increasing generating capacity and the need, for environmental reasons, to phase out small and inefficient generators in Guangdong (estimated to represent approximately one-third of total generating capacity). In addition, environmental issues will affect any substantial increase in coal-fired generation in Guangdong, which itself is starting to import power from western provinces.

Besides, in order for competition to work properly, our neighbouring provinces in the Chinese mainland would need to build a robust, efficient and reliable transmission and distribution network to provide a standard of service comparable to that currently enjoyed in Hong Kong. We estimate that this process alone could take approximately 10 to 15 years, allowing for the very significant work involved and the massive funding required.

So, the prospect of importing firm power from Guangdong, an essential component in any open market competition for Hong Kong, is unlikely for a considerable period of time.

CPI minus X, the formula whereby electricity tariffs are controlled relative to Hong Kong inflation, is not a viable solution, because less than 7% of CLP's tariff represents those costs which are more closely related to local inflation. The majority of our costs, such as depreciation, financing, purchase of nuclear electricity and fuel costs are unrelated to local inflation – meaning that this would not be an appropriate formula.

As regards merger between CLP and Hongkong Electric, both companies are publicly listed and own the electricity infrastructure in their respective supply areas. Any merger would be a matter for the approval of the shareholders in both companies – as opposed to a regulatory option. Moreover, insofar as the Government would have any role to play in this respect, I doubt whether the Government would see the consolidation of Hong Kong's electricity industry under a single supplier as being a preferred strategy.

JW: CLP has a mixed record of diversification outside Hong Kong. What lessons has the Management learned from CLP's overseas experience to date and what steps have been taken to ensure that future investments will enhance shareholder value?

AB: CLP's diversification in the electricity industry outside Hong Kong did not have a good start. But I am pleased to report that the performance of these businesses is improving. Earnings from our investments in the Mainland and the Asia-Pacific region almost doubled in 2002, reaching HK$1,150 million. Whilst I am encouraged by the strong growth recorded over the past year, it is important to bear in mind that the risk/reward profile of these investments will be more volatile than that of the Hong Kong SoC business. As we build up our investments outside Hong Kong, the performance of individual projects and assets within that portfolio will vary, both from year to year and by comparison to each other.

We have indeed learned from the successes and setbacks of these development businesses. The lessons, both positive and negative, which are of broader application would include:–

- The avoidance of paying for "blue sky", in the sense that we should not price into our evaluation of an asset or project, the future prospects which might emerge from developments in its regulatory environment. For example, in the case of the EGCO and YTL Power investments made in 1998 and 1999 respectively, we assumed future participation in the anticipated privatisation or opening up of the electricity generating markets in Thailand and Malaysia. Although these were reasonable expectations at the time, they did not materialise. The result was that, in effect, CLP bought an entry ticket to join in a game which has not yet been played.
- In reviewing generation projects, we are placing less reliance on formal aspects, such as power purchase agreements (which may be vulnerable to regulatory change or Government edict) and more on basic fundamentals such as availability and cost of fuel, competitiveness of generation cost, quality of the local transmission network and the local supply/demand balance for electricity.
- The importance of developing specialist management teams with high levels of expertise in business development, financing,

transactional skills and asset management. Some of these skills need to be sourced from outside the Hong Kong SoC business. We have steadily strengthened our management capabilities in terms of the specialist expertise required by our Mainland and Asia-Pacific businesses. In 2002, I made management changes in these businesses to reflect changing requirements, as they move forward from their start-up phases.

- CLP's diversification into the electricity sector outside Hong Kong can deliver value to our shareholders and avoid the Hong Kong SoC business being our sole source of earnings.
- CLP does have skills and expertise which can be effectively transplanted from Hong Kong to our businesses in the Mainland and Asia-Pacific. For example, during the past year we have been able to make a significant contribution to our joint venture in CLP Guohua, in the form of the introduction and application of CLP management and operating systems in areas such as safety and environmental performance, as well as financial controls and procedures.
- Our timing may be right. European and U.S. power players, with whom CLP would otherwise have been competing for assets and projects, have been withdrawing from Asia due to problems in their domestic markets.

In addition to applying the experience gained over recent years, the pursuit of investment opportunities outside Hong Kong will depend on those opportunities meeting our criteria in terms of price, earnings and risk profile. In 2000, I expressed our target of having one-third of our earnings from non-SoC operations by 2005. We have made progress towards this. But, as I said in last year's Annual Report, we will not pursue this target at the expense of inappropriate risk to shareholder returns. Our policy of diversification will be selective, prudent and incremental.

Alan Grieve, Global Relationship Manager, Hongs Division, HSBC (AG)

AG: There has been increasing pressure from various groups in Hong Kong to lower tariffs given the current economic conditions, notwithstanding the contractual nature of the return permitted under the SoC. This situation creates an inevitable tension between your customers and other stakeholders (lenders and shareholders). How does CLP seek to reconcile these two competing interests?

AB: Pressure on tariffs is not new. This has been part of Hong Kong's political and media landscape for many years. It is natural, too, that these pressures are heightened at times of economic uncertainty, deflation and in a political environment where grass root issues have particular weight. CLP is used to this pressure – and we welcome it. As a major public utility, it is natural that our operations come under close public scrutiny. This keeps us on our toes and sensitive to customers' interests. But it is misleading to focus on tariff in isolation. Review of CLP's activities should also take into account issues such as our performance by international benchmarks, supply quality and reliability, and environmental performance, as well as the need for reasonable returns so that capital providers, whether shareholders or lenders, are encouraged to support the long-term and large scale investment that our industry requires. In the section "CLP and our Customers" of this Annual

Report, we have set out some key performance data, which I hope will contribute to a more informed and broader view of the performance of CLP's Hong Kong electricity business.

Through improved operating efficiency and tight cost control, we can both manage tariff levels and preserve financial returns. Tariff management safeguards what is sometimes referred to as a "franchise from society" – the underlying support from the community that a public service provider such as CLP requires in order to preserve our right, and discharge our obligation, to serve that community. The interests of both shareholders and lenders are promoted by reasonable tariffs and high levels of customer service, in that they contribute to the continuation of that "franchise".

Whilst effective tariff management remains an ongoing priority, I question any large scope for tariff reduction. Our Hong Kong shareholders will be familiar with the phrase "structural deficit", as applied to the financial situation of the Hong Kong Government, whereby current revenues are insufficient to support recurring expenditure. For the time being, the Government can rely on the cushion of its financial reserves prudently accumulated over the past years. CLP's position is somewhat analogous. In recent years, Hong Kong tariffs have been supported through sales to Guangdong, and our efforts to cut costs and improve productivity. If this had not been the case, the slowdown in growth in electricity demand, coupled with current tariff levels and the need for ongoing investment in electricity infrastructure, would have given rise to a need to increase tariffs – despite our success in reducing costs and raising productivity. The Development Fund serves as a cushion and reserve against such tariff increases. In light of the uncertainty about future electricity revenues, including those from ongoing sales to Guangdong (which are "non-recurrent" in nature), it would be imprudent for CLP to reduce its revenues, run down reserves held through the Development Fund, and increase the likelihood of substantial and unwelcome tariff increases to our customers at a later date.

AG: CLP has placed significant emphasis on its environmental policies in previous annual reports. Can you explain how significant environmental considerations are in your business decision-making process particularly in respect of your overseas investments?

AB: CLP's environmental performance and policies are explained in this Annual Report, under the heading "CLP and Safety, Health and our Environment". We have made a particular effort over the past year to increase the attention we pay to the environmental performance of our investments outside Hong Kong. This is reflected in the Social and Environmental Report which we published in February 2003. This, for the first time, addresses CLP's environmental policies and achievements on a group-wide basis. The CLP Group's Value Framework, formulated in December 2002, includes a group environmental policy. This expresses our commitment to the responsible use of resources and environmental stewardship and, in particular, to:–

- Comply fully with all applicable environmental laws and regulations;
- Educate our people about environmental concerns and responsibility;
- Continuously improve our environmental performance;
- Monitor and report the environmental performance of our business;
- Support customers' improvements in energy efficiency; and

- Share our knowledge of environmental management practices with others in our industry.

To reinforce the implementation of these commitments, our "pay-for-performance" remuneration system includes good environmental stewardship as one of the factors we will take into account in determining performance-related pay for CLP staff. Tackling your question head on, our decision-making process is such that the Board, myself and line management will only support CLP engaging in investments in circumstances where these are compatible with our values and commitments.

Christopher Huang, Executive Director, Morgan Stanley (CH)

CH: In the past, CLP always considered having a local strategic partner as being an important pre-condition for overseas investments. Has the Company changed its philosophy in this regard?

AB: No, and with a couple of exceptions which I will mention shortly, having a local partner is a common thread in all our investments outside Hong Kong.

Although we are building a regional power business, our individual investments all have a strong local character. Whether because of the need for suitable sites, construction and environmental permits, electricity off-take and tariff arrangements or specific regulatory regimes, investment in power stations requires a close interface with local communities and their governments. A local partner allows us to manage these relationships more effectively and efficiently. We are fortunate that, in recent years, CLP's good reputation in the electricity industry has enabled us to build up a network of partnerships with established local industry leaders, such as Taiwan Cement Corporation in Taiwan, EGCO in Thailand and, in the Chinese mainland, the Beijing Guohua Group and Shandong Electric Power Group.

We do not yet have local partners in India and Australia with whom to take forward our investments in GPEC and Yallourn Energy, which we initially entered into through a joint venture with Powergen. As Powergen exits the joint venture during the course of 2003, we will be looking to bring in local partners, not only to contribute to the management of these assets, but also to work with us in building up, over time, a stronger presence in these markets. In India, we have a good relationship with the Tata Group. In Australia, we are currently looking for a local partner who shares our goal of establishing a long-term and meaningful presence in the electricity sector. I will be looking for progress on this during 2003.

CH: With an abundance of assets for sale in the global electricity market, especially in the Americas, would CLP consider investing outside the Asia-Pacific region?

AB: The short answer and for the foreseeable future is "no".

Our strategic choice has been to centre our development activities in the Mainland and Asia-Pacific region. This resulted from an assessment that we had, or could establish, a competitive advantage in those markets – whether as a result of longstanding previous experience in the market in question, or through partnership with local players with similar objectives and aspirations to our own. We do not readily see a competitive advantage in distant markets such as the Americas and we do not want to lose management focus by broadening our business beyond the current geographical spread.

Moreover, expansion in the electricity business is a highly capital intensive process. For example, we have to date invested approximately HK$13 billion in our Mainland and Asia-Pacific development businesses. CLP is conservative in its balance sheet and cash management. We must be selective in the application of our financial "firepower". Our view is that there are, and will be, sufficient opportunities for investment in our region, without the need to move further afield at this stage.

Jor Wing Cheung (second from right), a long-time CLP shareholder (JWC)

JWC: The CLP share price has been traded within a narrow range during the past few years. What will the Company do to improve its share price performance, say by 2 to 6% increase each year?

AB: You are absolutely right that CLP shares tend to trade in a narrow range. But I do not regard this as a bad thing – CLP is an electric utility and our positioning on the share market is as a long-term holding, providing capital stability (a firm share price) and worthwhile dividend yields. If you look at the figures set out in the "CLP and our Shareholders" section in this Annual Report, I think you will find we have delivered pretty well against these objectives.

It is difficult for any company to target a particular annual increase in share price. Firstly, share price changes will often reflect either developments which are unexpected to the investment community or the reinterpretation of existing information about a company. In CLP's case, we try to be open in explaining our strategy and performance and, as a utility, maintain a fairly predictable business model. So, the value of CLP will already largely be expressed in our share price. Secondly, CLP's share price will be affected by performance and trends in the Hong Kong and other stock markets. To give an example, at the height of the Internet boom in 1998/1999, CLP's share price under-performed the market, as investors were drawn towards the new "dotcoms" and away from more conventional stocks such as CLP. The trend has been reversed and, during the bear market of the last three years, our share price has out-performed the Hang Seng Index.

CLP's future share price will reflect our success in managing the existing Hong Kong electricity business, including any developments in its regulatory regime, and in building up a stream of earnings from our developing electricity businesses in the Mainland and Asia-Pacific. We have a very strong management focus on these core tasks. We are determined to bring these businesses to the point where they make a meaningful and sustainable contribution to overall Group earnings – in which case it would be reasonable to expect future positive movement in our share price to reflect this.

JWC: Has CLP considered installing wind, solar or hydropower systems for its remote supply areas, in view of the high costs of building transmission lines or laying underground cables in these areas?

AB: Yes, and as an environmentally responsible company, CLP is keen to make use of renewable energy opportunities. Experience elsewhere suggests that government support and policies have a role in promoting the development of renewable energy resources, including by ensuring that the wider economic and environmental trade-offs are balanced and the resulting costs and benefits fairly allocated. So, we will need to work with governments on this.

Let me give a little background on each of the technologies that you have mentioned and then describe some of the things that CLP is doing. I should acknowledge at the outset that one of the major challenges of renewable energy is that it does not always operate: such electricity is only available when the wind blows, the sun shines or the water flows. It needs to be backed up by conventional generating capacity and transmission systems. This, in turn, means that the provision of renewable energy systems can, from time to time, replace conventional generation output – it does not reduce the need to invest in conventional electricity generating capacity and transmission systems to provide the back-up.

A major factor affecting large scale wind projects in Hong Kong is the lack of land space. To give an example, to replace the output of one of the gas turbines at our Black Point Power Station (which can meet about one-twentieth of local maximum demand for electricity) would require approximately 200 wind turbines of 2.5MW each – using the wind data measured by the Hong Kong Observatory on Tai Mo Shan, the highest and one of the windiest spots in Hong Kong. This many turbines would require approximately 45 sq. km. of land – just over 4% of Hong Kong's total land area or almost the size of the Kowloon peninsula. Given space constraints, one promising area may be offshore wind farms. A further challenge for Hong Kong is that the windiest season tends to be in late autumn and winter, which does not match the high electricity demand in summer. This suggests that wind power can have a small but important role, although it may not displace much of our fossil-fuel based generation in Hong Kong.

Because of Hong Kong's climate, the resource is there for solar power. At present, solar energy is materially more expensive than other generation technologies. Hong Kong's densely populated urban areas present difficulties in terms of the location of the panels. New technological developments may provide some opportunities in this area. For example, there is a new building on Canton Road in Kowloon that has solar panels integrated as part of the building wall. This may be a start of a new trend by architects to design buildings with integrated solar panels.

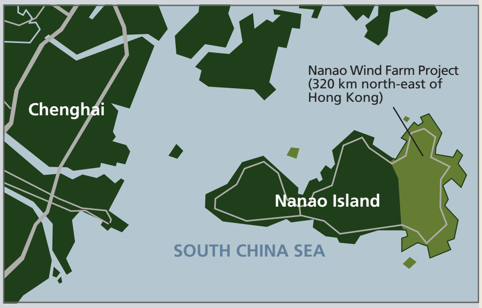
Hydro electric or geothermal power is viable and on a large scale. Unfortunately, Hong Kong lacks suitable locations for any meaningful development.

CLP has a policy of active involvement and encouragement of renewable energy sources which recognises and helps respond to these practical and technical challenges.

CLP – investing in renewable energy

Wind

The renewable energy supply system that we have installed on the island of Shek Kwu Chau includes a wind turbine, solar power system and a power house for the three-day battery supply system and standby generator. This project is giving us meaningful data regarding the application of such systems in Hong Kong, including the potential for wind power. Before any larger scale wind investment can be made in Hong Kong, a comprehensive wind resource map of Hong Kong needs to be created. This has not yet been done. CLP is working with academic institutions to see whether we can contribute to such a project. Having regard to space constraints in Hong Kong, we are looking at wind power opportunities in the Mainland. During 2002, we signed a letter of intent with Huaneng New Energy and Environment Protection Co., Ltd. for the development of a 100MW wind farm on Nanao Island off the Guangdong coast. CLP has also signed a letter of intent with the Yangjiang authorities to commence a feasibility study of the development of a 100MW wind power station on Hai Ling Island in Guangdong.



Solar

CLP is promoting a solar project at the Ma Wan Primary School (a side-by-side study of various solar photovoltaic panels) and is participating in the Tai Po Science Park's Building Integrated Photovoltaic project. We are also monitoring solar technology, through CLP Research Institute, to see whether and when it is brought to a point where it can be of more significant application in Hong Kong.

Hydro

In 1997, CLP acquired a 41.5% interest in the Huaiji power project in Guangdong, which comprises nine hydro power stations. This renewable energy project utilises the abundant water resources in Huaiji county and generates and supplies electricity to this remote county on the north-western border of Guangdong and to nearby areas. We are also looking at hydro electric projects in the west of China. Participation in these will depend on the availability of projects which are viable from an environmental, operational and investment perspective.

In 2003, we plan to launch CLP's renewable energy initiative in Hong Kong, which will be a two-year programme focusing on:–

- Renewable resource assessment;
- Renewable energy projects; and
- Renewable energy education and community support.

All in all, you can see that we are very aware of the role that renewable energy projects can play in our business. We are seeking opportunities to develop our skills and activities in this area, wherever and whenever practicable.