Chinese Mainland

Business Environment and Challenges

Strong growth in demand for electricity has continued in the Mainland, resulting in ongoing power shortages in some regions. New generation capacity currently under development is expected to lead to total installed generating capacity reaching 580GW by the end of 2006 and 650GW by the end of 2007 – an increase of 14% and 12% respectively on a year-on-year basis.

This new capacity will probably contribute to a better supply/demand balance being achieved in the medium to longer term. However, shortages will still exist in 2006 in the South China, North China and Central China regional grids. Over the long-term we expect volatility in the electricity sector to remain, in the form of significant swings in the supply/demand balance, due to continued regulatory changes and market uncertainties.

Against this background, the Beijing authorities have been taking measures to curb unauthorised power development projects, which amount to over 90,000MW in aggregate. A total of 50,000MW of unauthorised projects have already been ordered to be stopped, reflecting Government's determination to maintain investment discipline. Nonetheless, the majority of these are still expected ultimately to be built.

Notwithstanding the longer term uncertainty regarding the demand for additional electricity generation, competition amongst the five national generating companies and other Independent Power Producers (IPPs) remains intense. This competition is marked by:

- the willingness of the national generating companies and other IPPs to accept low investment returns, as they continue to focus on growth in size and market share;
- the advantageous position of domestic electricity producers to compete with external IPPs, such as CLP, due to their ability to manage coal price increases and fluctuations, by investing in upstream fuel supply businesses and their close relationship with regional grid companies;
- the successful IPOs in Hong Kong of Mainland power companies such as CPI and the Shenhua Group have put them in a stronger financial position with respect to other generators; and
- local IPPs, most of which were formed in recent years following the separation of power grid and generating activities, have an inside track on acquisitions and new project developments, due to their long-term and close relationships with local authorities.

Domestic coal prices in the Mainland have continued to increase in 2005, although there were signs of prices levelling off in the second half of the year. The development of new coal mines, coupled with improvement in rail transportation infrastructure, is expected to contribute to some further easing of coal prices in 2006 and onwards, albeit that the underlying increase in electricity demand (most of which will still be met by coal-fired generation) will maintain prices at high levels relative to those which were seen in the past.

In a business environment characterised by uncertainty in areas such as tariff management, project approval, regulatory reform and supply/demand balance management, as well as strong domestic competition in the electricity generating sector, CLP's strategy remains one of maintaining our position in the Mainland electricity market. Pending the effect of emerging reforms and a clearer picture of the future shape of the industry, we envisage:

- giving priority to the consolidation and effective management of existing assets, including the development of a business platform in South China to complement our Hong Kong business;
- developing and demonstrating the ability to build power plants using domestically sourced equipment and at capital costs that are competitive within the domestic market, as well as the ability to take direct control of the operation of power plants; and
- making selective strategic investments or divestments to strengthen the existing business and to achieve a closer strategic fit with our capabilities and priority areas.

Year 2006

During 2006, our aims are to:

- extract greater value from existing assets by pushing for higher tariffs, sourcing alternative coal supplies and reducing operating and maintenance costs and interest expenses;
- demonstrate excellence in the management of the Fangchenggang project, by maintaining construction progress to an exceptionally demanding schedule and controlling capital costs at domestically competitive levels. This will reinforce CLP's reputation as a credible developer and constructor of power stations in the Mainland and serve as a model for future projects with CLP as majority owner;
- take forward further investments in cleaner energy, such as gas-fired plants, hydro projects and wind energy, particularly where the renewable energy expertise of our Roaring 40s joint venture can be applied and exploited; and
- promote environmental improvement at those power stations in which CLP holds an interest, such as the retrofit and upgrade of emission abatement facilities for NO_x and SO_2 and the application of energy saving measures.

Beyond 2006

In the longer term, CLP looks to:

- move toward a locally-based development, construction and operations management team – with a view both to lowering costs and enhancing our expertise, knowledge and relationships in the Mainland;
- access domestic equity markets in order to improve our cost competitiveness, relative to domestic power producers;
- consolidate and rationalise our asset ownership structure, so as to exploit management and operational synergies more effectively; and
- explore the opportunities for broad-based strategic partnerships with major market players and IPPs, particularly in high growth regions, such as Eastern and Southern China.

Q: **Mr. David Clark** *Director, Head of Utilities Research, Asia, Deutsche Bank AG, Hong Kong Branch* (left)

CLP's ownership of a 25% stake in the Daya Bay Nuclear Power Station as well as its right and obligation to take 70% of the output from this plant expire in 2014. Is it likely that this arrangement will be extended (with respect to both the equity interest and the off-take contract)?

A: **Peter P. W. Tse** *Group Executive Director & Chief Financial Officer* (right)

Since operations commenced in 1994 Daya Bay has operated safely and reliably. It presently meets approximately 34% of CLP's electricity need in Kowloon and the New Territories. Our demand growth projections indicate that we will need to maintain this, or alternative generating capacity, after 2014. Our policy of maintaining a diversified fuel mix of nuclear, coal and gas has served our customers well in recent years. I am also conscious of the benefits of nuclear energy in reducing the greenhouse gas emissions associated with power generation to meet local electricity demand. I would welcome continued access to Daya Bay's output – provided that operational and commercial considerations are favourable. These would include equity and off-take arrangements on terms which, overall, are fair to CLP and our customers, and are favourable relative to other alternatives that are available to meet the local electricity demand.