

Hong Kong Electricity Business

Business Environment and Challenges

There are four major aspects of the business environment for our Hong Kong electricity business in the coming years, namely:

- the post-2008 regulatory regime;
- environmental issues related to air quality in Hong Kong and the emissions from our power stations;
- the need to progress fuel supply arrangements to take over from the gas presently sourced from the Yacheng-13 field in the South China Sea; and
- the overriding importance of maintaining the quality of our electricity supply in all respects, be it reliability, adequacy, customer service or tariff management.

The Chairman's Statement which introduces this Annual Report describes CLP's position regarding the post-2008 regulatory regime and emphasises the importance that this regime preserves the longstanding and stable balance between the interests of all the stakeholders in the Hong Kong electricity sector, including shareholders and consumer alike, which has been the hallmark of the Scheme of Control. The debate on that regime is likely to have a considerable political dimension. One of the challenges to CLP will be to ensure that, in this debate, proper and informed consideration is given to the long-term technical, operational, environmental and economic implications of the choices which need to be made.

In the past decade, air quality in Hong Kong has noticeably worsened, as evidenced by the increase in the frequency and severity of days of poor visibility. This worsening trend is likely to continue for some

years. Although the overwhelming majority of emissions affecting Hong Kong's air quality originate from elsewhere in the Pearl River Delta, our community and our environmental and economic regulators will expect CLP to play its part in reducing emissions from our power stations – and we expect no less from ourselves.

CLP operates with a diversified fuel mix of coal, gas and nuclear to ensure that power is available even if there are interruptions on any one fuel source. In 2003 fuel availability issues resulted in a readjustment of our fuel mix. The reserves from the Yacheng-13 gas field, which supplies Black Point Power Station, are lower than estimated when the gas field was first evaluated in the early 1990's. With limited gas resources in the region, CLP will need to make arrangements to import liquefied natural gas (LNG) by sea to Hong Kong for use early in the next decade. This will also better position CLP to increase the use of gas, as opposed to coal, to meet the increasing local demand for electricity and contribute to further improvements in environmental performance.

Over the next five years, that demand growth is forecast to be around 3%. This reflects, amongst other factors, the Hong Kong Government's commitment to an average annual budget of HK\$29 billion on its infrastructure projects and the steady increase in new towns and housing developments in our supply area. We must meet this additional demand for our services by continuing to make timely investments in our electricity system. At the same time, we must maintain the reliability and quality of service which our customers expect and which we have a duty to provide.

In response to our business environment and the challenges we face, our major plans and activities in 2005 will include:

- active participation in the debate on the future regulation of our business. We will respond clearly and with authority to the consultation launched by Government and communicate widely with all sectors of our community regarding the right way forward for this essential industry;
- taking forward our plan to raise the environmental performance of our coal-fired plant in Hong Kong to state-of-the-art levels, as promised in the CLP Group Action Plan which formed part of our 2004 Manifesto. This will involve close liaison with Government to ensure that the economic and environmental parameters for this project are clearly established before major commitments are made, including as to the terms of the relevant environmental licences for our plant;
- working with Government and other stakeholders to bring LNG to Hong Kong and, in particular, moving forward with the selection of possible sites and related environmental impact assessments. The interface with Government at the working level has already been valuable and constructive. High level policy support will be necessary for the LNG project to move ahead. There will also be a considerable exercise of communication and information so that all parties concerned have a proper understanding of what is involved in this project and the timetable by which the various steps required must be completed. The public and other interested stakeholders will be consulted throughout our planning process; and
- continuing to invest in our system and to enhance our operating skills. As part of the former, we need to secure Government approval of our Financial Plan, submitted in 2004, which sets out CLP's projections of our revenues, capital budgets, financing plans and tariff levels for the period through to 2008. The continued construction and commissioning of the remaining two units at Black Point Power Station within budget and to a schedule which brings them into service in 2005/6 is a major exercise for our generation business.

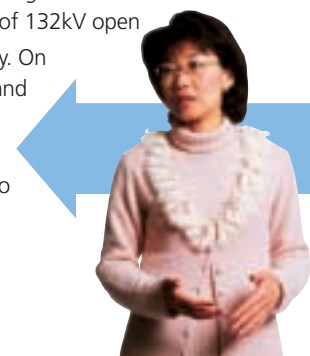
Could CLP management comment on medium-term demand growth outlook in HK, the current state of its power network and generation facilities and hence any major capital expenditure work to be expected for the next few years?



Mr. Bill Laukka
Managing Director,
J.P. Morgan Securities (Asia Pacific) Ltd.

Our capital expenditure plans reflect both the need to meet growth in demand and to ensure that the quality of the electricity supply provided to all customers continues to meet their expectations. Our Financial Plan for the period 2005 to 2008 is currently with Government for review. I would not want to pre-empt the outcome of Government's deliberations on this. However, I can say that, over the period to 2008, the main focus will be on investment in our transmission system in order to keep pace with electricity demand growth and to maintain high supply reliability for the longer-term future. This will include projects such as an increase in our 132kV circuits, phasing out of obsolete 33kV systems for general customers and the establishment of 132kV open

ring arrangements to enhance supply security and operating flexibility. On the generation side, we will complete the commissioning of units 7 and 8 at Black Point and look to start work on additional emissions reduction plant at Castle Peak. Investment in customer services is expected to include the installation of around 500,000 new meters to cope with natural customer growth and to replace aging meters for existing customers to ensure continuing confidence in data accuracy.




Betty Yuen
Managing Director,
CLP Power Hong Kong

Beyond 2005

Our plans and activities beyond 2005 can be fitted into the same four-part framework.

- To maintain confidence to support the ongoing capital investment required in our business and to maintain quality of electricity supply, CLP and its shareholders will be looking to Government to provide a suitable degree of assurance and clarity about the post-2008 regulatory regime as soon as possible and, in any event, by no later than 2006. We will then need to evaluate the implications of any changes to the SoC and how the manner in which we carry on our business needs to be adapted or modified.
- Our proposed package of emissions reductions investments at Castle Peak Power Station is aimed to be completed around the turn of the decade. This will bring the SO₂, NO_x and particulate emission performance to better than the European Union standards for existing coal plant.
- The development of the LNG terminal and the whole LNG supply chain by 2011 is crucial to our business, including with respect to both adequacy and reliability of supply and environmental performance. By 2007 we target to have the site secured and relevant approvals finalised so that commercial contracts can be awarded in time to enable work on upstream development, shipbuilding and site construction to then move forward.
- We must maintain our excellent record in tariff management, meaning that cost-control and efficiency disciplines must be tightly applied. To meet our customers' needs and to ensure their continued support for CLP as the long-term electricity supplier of choice, we will need to match cost-competitiveness with excellence in customer services and enhance the management of strategic customer accounts.



Is interconnection with China a remote possibility?

Technically, we have been interconnected with the Mainland since 1979 (even earlier than our interconnection with Hongkong Electric which was put in place in 1981). In 1992, the Mainland interconnection was upgraded to 400kV. Electricity sales to the Mainland first peaked in 1995 (see the ten-year statistics on page 170) and have increased significantly in the last couple of years due to rapid and economic growth in Guangdong and resulting electricity shortages.

We are, however, a long way from the possibility of Hong Kong's electricity system being operated as part of a South China market. Technically there are problems of electricity supply shortage, grid reliability and transmission constraints in Guangdong. From a broader perspective, the alignment of institutional, legal and commercial (such as price-setting) practices will take considerable effort, resources and time to resolve.

Mr. Patrick Lo
Country Fund Manager,
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Andrew Brandler
Chief Executive Officer