



ENERGISING Hong Kong for a brighter future

MAINTAINING reliable power night and day

AIMING for even higher service standards

ENCOURAGING our talented people to excel

FULFILLING our responsibilities to the community

BROADENING our view of the world

Chairman's Message

2004 was a year of challenges for our business in Hong Kong and opportunities overseas. The local economy recovered favourably from the devastating effects of the outbreak of Severe Acute Respiratory Syndrome in 2003, and benefited from supportive measures such as improved arrangements leading to the increase in Mainland visitors. The Company recorded a new system maximum demand of 2,588 MW, an increase of 6.1% over 2003, and attained the exceptional reliability of supply rating of 99.999%, a mark now achieved continuously since 1997. However, during the year we faced major cost increases beyond our control: the price of coal soared more than two and a half times over 2003 levels; freight charges tripled; and there was a substantial increase in Government rates. In addition, electricity consumption did not match the increase in maximum demand and was lower than expected, mainly due to unusually cool weather during the second half of the year. These factors, together with the tariff freeze announced for 2004, resulted in our local business earning less than the permitted return specified in the Scheme of Control Agreement. Overseas, our operations in Australia continued to perform strongly, and we extended our international investment portfolio to the United Kingdom by acquiring a 19.9% stake in North of England Gas Distribution Network.

Results

The Group's audited consolidated net profit after tax for the year ended 31st December 2004 was HK\$6,280 million (2003: HK\$6,057 million), an increase of 3.7%. This result included profits from the Group's overseas activities of HK\$759 million (2003: HK\$437 million).

Final Dividend

The Directors will recommend a final dividend of HK\$1.19 per share. This, together with the interim dividend of 58 cents per share, will give a total dividend of HK\$1.77 per share for the year (2003: HK\$1.71).

Hong Kong Operations

In 2004, unforeseen increases in operating costs fuelled by volatile coal and freight markets had a significant impact on our business. At one point in the summer, coal prices, including freight charges, rose to approximately US\$72 per tonne from approximately US\$29 per tonne at the same time in 2003. Although the Company was insulated from the full effect of these increases by virtue of several prudent longer term supply contracts

secured at favourable prices, a two-cent per unit reduction in the Fuel Clause rebate went into effect 1st April 2004 to recover the increase in fuel costs for the year. This was a pass through of actual cost increases incurred in accordance with the Scheme of Control Agreement.

The stronger local economy, coupled with hot and humid weather towards the end of June, resulted in a new system maximum demand of 2,588 MW, an increase of 6.1% over the maximum demand of 2,440 MW in 2003. However, this increase in maximum demand was not matched by electricity consumption due to cooler weather experienced in July and August. Total unit sales of electricity for 2004 were only 1.7% above 2003, and this, together with a substantial increase in Government rates, were the significant factors resulting in earnings below the permitted level specified in the Scheme of Control Agreement.

The spike recorded in the maximum demand is a timely reminder of the importance of making long term investments in our electricity infrastructure well in advance of demand growth, and is further evidence that the target commissioning in 2006 of the new L9 unit at Lamma Power Station is necessary.

Chairman's Message

Satisfactory progress continues to be made on this project. The piling work for the first 300 MW power unit was completed and superstructure works commenced in March 2004. Work on the Main Station Building and the 275kV Switching Station is on schedule and the manufacture of the power block equipment is in progress.

As natural gas will be the fuel for our future power units, a long term contract for the supply of natural gas to Lamma was signed in Beijing in April 2004. The first delivery of gas from the Guangdong LNG Terminal, which is presently under construction in Shenzhen, is targeted for mid-2006. The contract for the supply and installation of a 93 km submarine gas pipeline from Shenzhen to Lamma was awarded in May 2004. Pipe laying work will commence in early 2005. In addition, the contract for the supply and installation of the gas receiving station was awarded in December 2004.

The Company's long tradition of environmental responsibility was recognised by the Pacific Basin Economic Council (PBEC) in June when the Company received a PBEC Environmental Award, the first time that an electricity utility in the region has been honoured. The Award commends our unique approach to eco-efficiency and sustainable development including the installation of Flue Gas Desulphurisation and the use of low Nitrogen Oxides (NOx) burners which can respectively remove over 90% of sulphur dioxide and reduce by two-third the concentration of NOx in the flue gas.

As a result of the Company's efforts to explore the use of renewable energy in Hong Kong, our land application for a wind turbine site on Lamma Island was approved in November 2004. The contract for the supply of an 800 kW wind turbine was awarded in December 2004 to meet a commissioning target in early 2006. The Lamma turbine is a first step and as a pilot project, it will provide us with important practical experience for the future.

The ongoing development and enhancement of our distribution and transmission network continued with a total of 47 new distribution substations being commissioned in 2004, bringing the total number of substations in service to 3,570. These, together

with new cabling totaling over 180 km, improved our ability to transport electricity efficiently to our customers' homes and offices.

In 2004, we maintained our record of achieving a supply reliability rating of 99.999%, a mark continuously achieved since 1997 and which surpasses our pledged service standard. All other service standards were achieved or surpassed during the year, while two were upgraded and a new one was added. It was also another record year for the number of commendations we received from our customers, reflecting a high level of customer satisfaction.

Improving the well-being of the community continues to be a prime objective and our Hongkong Electric Volunteers, a group of over 600 employees, donated their time to help ordinary citizens and the Company conducted several programmes to benefit the elderly in particular.

We rolled out the Smart Power Campaign to primary school students in late 2004 following the Campaign's success the year before. A series of educational activities were specially designed for young children to teach them the importance of electricity and to help them develop the good habits of using electricity smartly. Thousands of secondary school students participated in the Campaign in 2004, and 38 schools also benefited from energy audits provided by professional HEC staff.

Overseas Business

Our operations in Australia continue to perform well. Strong financial performance was achieved through a combination of customer growth, increased consumption, growth in non-electricity revenue and productivity improvements within and across the businesses. The reliability performance of the distribution networks was excellent, with Powercor and CitiPower achieving their best result ever.

In addition, under Australia's new tax consolidation rules, Powercor benefited from a one-off reduction in its deferred tax liability, further enhancing its financial results for 2004.

In Thailand, the shareholding arrangements in the consortium formed to develop a 1,400 MW gas-fired power plant were finalised in February 2004.

The Group is the largest foreign shareholder of the Ratchaburi Power Company with a 25% interest in the project. Financing is progressing and the project is on schedule for commissioning in 2008.

In December 2004, we entered into an agreement with Cheung Kong Infrastructure Holdings Ltd. (CKI) to acquire a 19.9% stake in the North of England Gas Distribution Network. This serves to extend our successful partnership with CKI to the United Kingdom. Our substantial expertise in managing and operating distribution networks under a regulated environment in the electricity industry should help us to succeed in the gas distribution business. We are also confident that we can use this acquisition as a platform from which we can make further investments in Europe.

Associated Technical Services Limited, a wholly-owned subsidiary of Hongkong Electric Holdings Limited, secured three new consultancy projects in 2004 in Libya, the Philippines and Thailand.

Outlook

In Hong Kong, a strengthening economy gives us cause for optimism in the medium term. However, the coal and freight markets will continue to be volatile and beyond our control. Nevertheless, we will do our utmost to negotiate and fix the lowest possible coal prices. We also remain steadfast in our commitment to provide our consumers with reliable electricity to satisfy current and future demand at the lowest cost compatible with the terms of the Scheme of Control Agreement with Government.

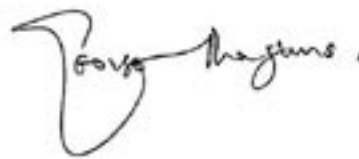
As regards the longer term, the Government has recently embarked on the first phase of a public consultation process designed to assist in the formulation of a regulatory framework for the period following the end of the current Scheme of Control Agreement in December 2008. We welcome this process and look forward to participating in a rational discussion on the formulation of a framework which will continue to balance appropriately the rights of shareholders to a reasonable return on their long term investments and the assets which they own, with the demands by consumers for certainty of connection and the highest levels of reliability required

for a world class financial centre compatible with economic operating expenses and improving the quality of our environment. We trust the consultation process will give due credit to the proven achievements of the existing Scheme of Control arrangement, which in addition to appropriately balancing the interests of consumers and investors, provides Government with a mechanism to monitor capital expenditure, operating costs and tariffs, and at the same time ensuring adequacy and reliability of supply and stringent environmental compliance.

Hong Kong consumers have enjoyed an exceptional level of supply reliability for such a considerable period of time that there is a danger that this is now taken for granted. It should be recognized that any dampening of investors' appetite to continue to make the substantial long term investment that underpins this reliability would have far-reaching consequences which, as experience from other parts of the world has shown, would be very difficult and extremely costly to rectify.

The relatively lower risk and predictable nature of our overseas businesses provide support for sustained profit growth. We will continue to leverage on our existing resources and expertise to explore new business opportunities and concentrate on selected markets which offer stable returns with manageable risks.

Guided by the Company's Vision, Mission and Core Values, our Directors and employees have maintained exceptional supply reliability, improved customer services and increased cost-effectiveness in daily operations. Their commitment to hard work and innovative solutions continues to reap benefits for our customers and investors. For this I thank you all.



George C. Magnus

Chairman

Hong Kong, 10th March 2005