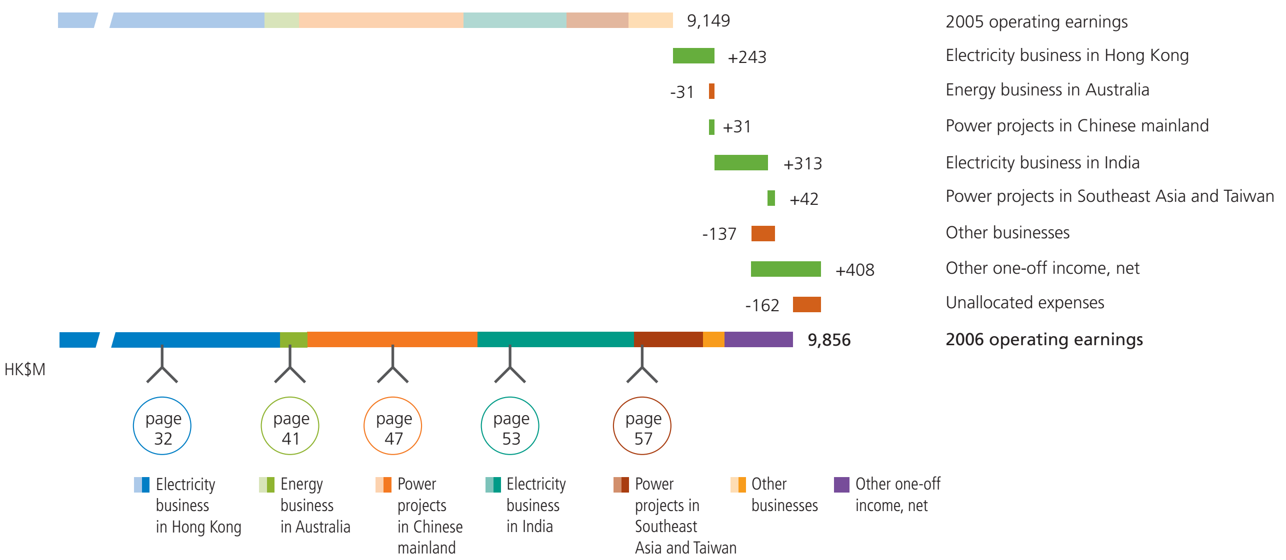
CEO's Review

Leadership in our industry will belong to those who most quickly identify and master the drivers of change.

Andrew Brandler

The CLP Group's operating earnings for 2006 were HK$9,856 million, a 7.7% increase on our results for the previous year. Total earnings, including Hok Un redevelopment profit, amounted to HK$9,900 million and were 13.3% below 2005 earnings, which included a tax consolidation benefit of HK$2,004 million from the Australian business.

Group Operating Earnings



The earnings from our Hong Kong electricity business continued to represent the largest part of the Group's total earnings, making a contribution of HK$7,290 million in 2006, compared to HK$7,047 million in 2005.

Operating earnings before unallocated expenses from our energy businesses outside Hong Kong recorded an encouraging increase, contributing a total of HK$2,894 million to the Group's total earnings, up from HK$2,131 million in the previous year.

Included in operating earnings are one-off gains totalling HK$408 million. Upon the formation in March 2006 of OneEnergy Limited, a strategic joint venture in partnership with Mitsubishi Corporation of Japan, a one-off gain of HK$343 million was realised. In December 2006, our interest in BLCP Power Limited was transferred to Electricity Generating Public Company Limited, Thailand and another one-off gain of

HK$888 million was recorded. An impairment of HK$823 million (after tax) was provided for our investment in Yallourn Power Station of Australia as a result of lower forecast electricity pool prices and reductions in performance of its ageing plant.

Operating earnings per share of HK$4.09 (2005: HK$3.80) increased by 7.7%, whilst total earnings per share decreased by 13.3% to HK$4.11 per share from HK$4.74 per share in 2005 which included the tax consolidation benefit in Australia.

The following sections of this Annual Report explain the performance of our businesses in each of the five areas within the Asia-Pacific region in which CLP currently operates. Recognising that shareholders and, for that matter, other stakeholders, may be more interested in future prospects than past performance, we have expanded our explanation of the business environment and challenges encountered by our various businesses and their objectives and outlook for the years ahead. Recent changes to accounting standards and regulations may have had praiseworthy objectives, but improving the clarity and user-friendliness of financial reporting for the average informed reader has not necessarily been one of them. To assist those of our shareholders who are neither expert accountants nor financial analysts, we have made a particular effort in this year's Annual Report to make the presentation of our financial performance easier to follow.

In this CEO's Review, I want to discuss the broader business environment within which the Group operates, highlight some of the particular challenges we face and identify some of the strengths of the CLP Group which we need to exploit in order to sustain a durable and successful presence in Asia's energy sector.

The Asia-Pacific Electricity Industry

In broad terms, the business environment for electricity investors in the Asia-Pacific region is strongly influenced by three factors:

- An increasing demand for power;
- A constantly evolving market background including fierce competition for existing assets and greenfield projects; and
- The growing importance of environmental issues.

Electricity Demand

Demand for electricity in the Asia-Pacific region has been increasing rapidly, in line with significant economic growth in the region. Meeting this demand, and responding to the aspirations of the region's people for ready access to affordable power to improve their living standards, requires a major expansion in generation and transmission infrastructure throughout the region. There is a strong need for further massive investment, particularly in countries such as China, India, Vietnam and Indonesia – all of which have large and growing populations. The region as a whole is presently experiencing close to double digit GDP growth. By way of example, installed generating capacity in Mainland China grew by 105,000MW in 2006 and now stands at 622,000MW (for

How important is it for CLP to grow its Asia-Pacific operations/assets?

Mr. Simon Powell
Head of Power Research, CLSA Research Limited

This is one of management's priorities. Although the Hong Kong electricity business continues to provide the lion's share of CLP's operating earnings, Hong Kong is a relatively mature market, which has seen a slowdown in the growth in local electricity demand. During the 1980s, average year-on-year growth in electricity demand was 8.5%. Through the 1990s this slowed to 4.4%, a trend which has continued since the turn of the century, with growth in demand averaging only 2.3%. This business has also been subject to regulatory uncertainty as we approach the expiry of the SoC in 2008.

Our Asia-Pacific operations have grown steadily over the past decade – providing 29% of Group earnings in 2006, compared to 6% in 1996. Whilst still overshadowed by the level of our Hong Kong earnings, diversifying our investments outside Hong Kong not only provides protection to shareholders from regulatory and market risk in Hong Kong, but also offers significant opportunities for future growth.

I expect the contributions from these investments will continue to increase, even if I do not want to set specific targets for the growth in our Asia-Pacific earnings. This largely depends on the availability of opportunities which meet our investment criteria – above all, the reasonable prospect of delivering sustainable shareholder value over the medium to longer term, commensurate with the degree of risks which those investments involve.

Andrew Brandler
Chief Executive Officer

comparison, the total generating capacity in Australia is 47,091MW). On average, one large new coal-fired generating plant is entering operation every five days in the Mainland. The scale of the investment required goes beyond the capacities of individual governments and can only be satisfied by significant involvement from the private sector.

Although economic growth rates may not be sustainable at current levels, there is still much scope to increase energy intensity and to bring reliable and adequate electricity supplies to populations who have never enjoyed its benefits and whose expectations of an improved way of life are unlikely to be dampened by fluctuations in the global and regional economy. Over the long run, growth in demand for electricity seems highly likely to continue throughout the developing economies of our region.

Market Background

The potentially robust growth opportunities in the regional power sector have become increasingly attractive to investors, after a calmer period following the Asian financial crisis in the late 1990s. While we have continued to see the withdrawal of European and U.S. power companies from the region, we have observed the emergence of strong national and regional players in the electricity industry, with ready access to funding on a large scale.

The combination of growth opportunities, emerging players and cheap capital has led to intense competition to buy existing power assets or the rights to develop new projects. This creates an environment where revenue projections are unduly optimistic, sub-optimal rates of return are accepted in the pursuit of growth and the risk premium associated with such investments (particularly in developing countries) may be inadequately priced. Particularly at present, those risks are real and substantial – such as volatile and rising fuel costs, increased prices and less favourable terms available from equipment suppliers (reflecting the world-wide demand for new generating plant, including in Europe and the U.S.), as well as unsettled market and regulatory regimes.

This last point is an important consideration for the energy sector. Power assets, by their nature, are often large scale, immobile and unable to serve more than a single market. This means that investors are vulnerable to "hold-up" risk. This arises when an investment is made based on seemingly credible expectations regarding market or regulatory structures or rules, but the investor is forced to absorb the cost of a change in those structures or rules after the investment has already been made. This risk, which is greatest during periods of excess electricity supply or poor economic performance, demands both careful pre-investment evaluation and, subsequently, active management by investors in the electricity sector.

Over 2006, CLP has witnessed intense competition firsthand during the course of unsuccessful bids for existing assets or greenfield projects, ranging from a generating portfolio in the Philippines, a retail energy business in Queensland and coal-fired power station projects in India. In line with good management practice, after each unsuccessful bid we have reviewed our approach including, as the case may be, the price we were prepared to pay, the prices at which we believed we could generate electricity profitably and the risks we were prepared to accept. In each case, even with hindsight, we were satisfied that our bids reflected a "fair price" for the assets or projects in question, the acceptance of a reasonable degree of risk and a reasonable prospect of creating value for our shareholders.

Although we may have been disappointed not to have been able to expand our business more rapidly, I am satisfied that CLP's prudent and disciplined approach to new investment in the current environment is in line with our objective of providing long-term, sustainable earnings growth for our shareholders and corresponds to the mandate which Management has been given by our Board and which, in turn, our Board is given by our shareholders. Markets are cyclical. Care must be taken to look beyond the current market phase and aim to balance risks and returns over the longer term.

→ (Left) Go Green Launching Ceremony 2006

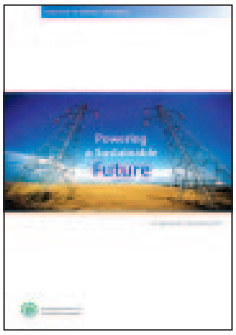
→ (Right) Meeting Mr. Yoshiaki Katayama, Senior Vice President and Division COO of Mitsubishi Corporation, at the formation of OneEnergy

In practice, this requires CLP to adopt a structured and disciplined approach in its investment decision making, with a view to ensuring that regulatory and market risks are identified, their cost implications objectively evaluated and mitigation measures adopted. Once the investment is made, these risks have to be managed on an ongoing basis, through measures such as cost control, collaborative relationships with governments and regulators, joint ventures with strong local partners and maintaining diversity in the investment portfolio. As this Annual Report explains, all of these considerations feature in the ongoing management by CLP of its assets and investments.

Social Responsibility – Managing Climate Change

Working within the context of international, national and local laws and regulations, power companies, such as CLP, have a duty to operate responsibly and, in doing so, safeguard their franchise to do business from the governments, communities and customers they serve.

During the past eighteen months, I have had the personal opportunity to work with leading figures in the world's electricity business, through the World Business Council for Sustainable Development. CLP and seven other leading companies in the global electricity sector recently issued a joint report, "Powering a Sustainable Future".



In this Report, we articulate our shared view of the efforts that must be made by businesses, governments and consumers, to tackle key sustainability challenges in the electricity sector, including climate change (see www.wbcsd.org). As the WBCSD has noted, electricity is at the heart of the global energy challenge. On the one hand, it is a necessity of modern life and a basic requirement for development; at its point of use, electricity is the cleanest and most convenient energy carrier and its share of energy consumption is growing. On the other hand, the power sector produces around 40% of global CO_2 emissions from fuel combustion and, therefore, contributes significantly to the risks associated with global warming.

We have gone beyond the point where scientific, political and public concern about global warming can be dismissed as unfounded or unnecessary. In February this year, the Intergovernmental Panel on Climate Change's 4th assessment report on the physical science confirmed, "Warming of the climate system is unequivocal, as is now evident from observations of increases in global average air and ocean temperatures, widespread melting of snow and ice, and rising global mean sea level". The Stern Review in the U.K. published in October 2006 warned that "the scientific evidence points to increasing risks of serious, irreversible impact from climate change associated with business-as-usual paths for emissions" and pointed out the threat that this posed to the basic elements of life for people around the world – access to water, food production, health, and use of land and the environment.

CLP's sense of social responsibility requires us to respond to the challenge of climate change and to play our part in creating a sustainable power sector which meets society's need for electricity without jeopardising the environment. We face a particular dilemma in this respect, in that we operate in a region where, mainly because of considerations such as affordability and availability, coal is the fuel of choice for large scale electricity generation – whilst, as at today, there are no large scale and economically viable technical solutions to capture and store the CO_2 emissions created by such plant.

Governments have started to respond to concerns on climate change. In our region, recent months have seen the introduction of mandatory renewable energy targets in China and India, as well as new targets in two Australian states.

Power companies do not create the demand for electricity – our role is to meet that demand responsibly. For the time being, politicians, including those with a genuine awareness of the risk of climate change, are focusing their attention on the environmental regulation and control of the power companies

→ Visiting Changdao Wind Farm, Shandong Province

which produce electricity, rather than on changes to the attitudes and behaviour of the businesses and individuals who demand and consume that electricity, including through price signals which may moderate consumption patterns. Addressing the problems associated with CO_2 emissions will require a collective effort from society and an open and constructive political debate on the choices to be made. And the uncomfortable truth is that this will involve all of us accepting changes in our way of life and doing business, and paying a fair share of the economic cost of reducing emissions. Responsibility to society, current and future, rests with all of us.

Taking these major issues back to CLP's position as a leading player in the regional energy sector, I believe that we must incorporate the implications of climate change into all our investment decisions and into the ongoing operation, maintenance and enhancement of our existing assets. This will involve a balanced portfolio using a range of fuels and technologies. For the foreseeable future, coal will continue to play a major role in power generation in the region in order to meet people's demand for electricity at reasonable prices. Our corporate strategy must recognise that, in the long term, ownership of a generating portfolio dominated by conventional coal-fired plant is likely to be an unsustainable and exposed position, as growing emphasis is given to other fuel sources, such as gas, nuclear and renewable energy, and new technology emerges to harness the energy locked-up in coal, such as integrated gasification combined-cycle plant with carbon capture and storage, to allow for future coal-fired generation to operate on an environmentally sustainable basis.

Looking Ahead

In order to realise its vision of being a leading investor-operator in the Asia-Pacific power sector, CLP must have a competitive edge which allows us to succeed in a market characterised by strong growth in electricity demand, fierce competition, market and regulatory uncertainty and the implications of climate change. CLP is well positioned to maintain that competitive edge. We have

- expertise in a variety of technologies and fuel sources and a good track record in the promotion and adoption of new technology (as shown by our role in the early development of nuclear power in the Mainland and combined-cycle gas technology in Hong Kong);
- the geographical range of our operations, combined with good local relationships, which allows us to allocate capital and make investment decisions by reference to the particular economic and environmental conditions in the countries in which we choose to do business;
- preserved a strong financial position, which gives us the capacity to invest in the growth of our business when opportunities arise which meet our criteria in terms of the rewards they offer and the risks they involve;
- high standards of corporate governance, including internal financial and operating controls, which give us credibility with all those with whom we do business and all those upon whose support we rely. Our corporate governance disciplines also ensure that social and environmental considerations are implanted in our investment and decision-making processes;
- already demonstrated our willingness to be proactive in addressing the environmental implications of our business by our self-imposed target set in 2004 of generating 5% of our energy from renewable energy resources by 2010, our commitment to incorporate modern emissions control equipment, such as flue gas desulphurisation, into the planning of new greenfield coal plants, and the adoption and implementation of our climate change strategy. CLP enjoys the firm support of our Board and shareholders to be amongst the leaders in the Asian power industry in shouldering our environmental responsibilities; and
- the capacity to exploit the group synergies present in a business which operates on a large scale with a wealth of experience throughout the region – even if, because of the rapid expansion of the Group in recent years, we still need to do further work in maximising our organisational effectiveness in this area.

The regional power industry is going through a period of massive change and uncertainty – arising from the overarching challenge of meeting growing electricity demand in an affordable yet environmentally sustainable manner. Existing incumbents in the power sector will not necessarily benefit from their entrenched and current positions. Leadership in this industry, as with any industry under transformation, will belong to those who have most quickly identified and mastered the drivers of change and exploited the opportunities that this presents. Although the task is a demanding one, I am determined and confident that CLP will manage risk effectively and be amongst those companies who succeed.

Andrew Brandler

Andrew Brandler
Hong Kong, 28 February 2007