

Chairman's Statement

The year 2006 saw continued challenges for our electricity business in Hong Kong. Unit sales of electricity grew by only 0.2% in 2006 compared with 1.5% in 2005, maximum demand in 2006 was 2,597 MW (2,565 MW in 2005). Unit sales growth in 2006 was negatively impacted by a cooler than normal summer as well as the effect of various energy savings initiatives. Higher fuel costs continued to apply pressure on tariffs in 2006. These factors together with the

fact that The Hongkong Electric Co., Ltd. (HEC) continued to charge lower electricity tariffs than it is entitled to do under the scheme of control in order to minimise tariff increases for its customers resulted in HEC earning less than the permitted return specified in the scheme of control for the fourth consecutive year. Reliability was however not compromised in 2006 and our customers continued to enjoy reliability in electricity supply of over 99.999%. This is a world class reliability level that is often taken for granted in Hong Kong however as was seen during the summer of 2006 it is a level of reliability not enjoyed elsewhere particularly in parts of North America and Europe. Maintaining this high standard of reliability which Hong Kong residents have come to expect and which Hong Kong as a leading financial centre has come to rely on continues to be our highest priority.

Outside of Hong Kong, the Group's international operations continued to perform well in 2006. Excluding extraordinary items and non-cash tax adjustments recorded in 2005 and the Group's lower attributable interest in the Australian electricity distribution businesses in 2006, the results for the Group's international operations in 2006 compared favourably with those achieved in 2005.



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Results

The Group's audited consolidated net profit after tax for the year ended 31st December 2006 was HK\$6,842 million (2005 : HK\$8,562 million), a decrease of 20%. Earnings from the Group's Hong Kong operations were HK\$6,173 million (2005 : HK\$5,508 million), the higher earnings in 2006 were primarily due to the lower HEC special subsidy and operating costs and lower Group financing costs. Earnings from the Group's international operations were HK\$669 million (2005 : HK\$3,054 million). The lower international operations earnings in 2006 were primarily due to the exceptional gain of HK\$1,560 million and non-cash tax adjustment of HK\$648 million recorded in the international operations results in 2005. In addition, the Group's interest in the Australian electricity businesses was reduced from 50% to 27.93% at the end of 2005.

Final Dividend

The Directors will recommend a final dividend of HK\$1.27 per share, payable on 11th May 2007 to those persons registered as shareholders on 10th May 2007. This, together with the interim dividend of HK\$0.58 per share, will give a total dividend of HK\$1.85 per share for the year (2005 : HK\$1.59 per share total ordinary dividend and HK\$0.73 per share special dividend totalling HK\$2.32 per share).

Hong Kong Operations

With the commissioning of HEC's first gas-fired combined cycle unit, Unit 9, in October 2006 the generating capacity of the Lamma Power Station increased from 3,420 MW to 3,755 MW. The addition of Unit 9 will enable HEC to reduce emissions from the Lamma Power Station through the increased use of gas and help to meet future electricity demand. The associated infrastructure for Unit 9 which is housed in the Lamma Power Station Extension and the 93km submarine gas pipeline from the Guangdong Dapeng Liquefied Natural Gas Terminal in Shenzhen were completed on time enabling the commissioning of Unit 9 on schedule and within budget. Further emission reduction activity continued during the year at the

Lamma Power Station with the awarding of contracts for the installation of two flue gas desulphurisation units. These new units are in addition to the three desulphurisation units already installed.

Lamma Winds, the wind turbine on Lamma Island and its associated exhibition centre has become a popular educational tool on renewable energy. From its official commissioning in February 2006 to the end of 2006, the wind turbine has generated approximately 700,000 kWh. The wind turbine, the first in Hong Kong, is our first venture into renewable energy. It is providing us with valuable information and experience in the operation of wind turbines which will benefit us as we evaluate our proposed 100 MW wind farm for which we are currently undertaking preliminary environment impact assessment work.

High coal prices continued to put pressure on fuel costs in 2006. In order to mitigate the impact of higher prices we continued to source and use a wide variety of coal during the year. Coal prices have remained high during the early part of 2007 notwithstanding the lower oil prices.

In 2006, the highest reliability rating since our reliability targets were first published in 1993 was achieved. A supply reliability rating of 99.999% has been consistently achieved since 1997. All of our pledged service standards were met in 2006 and a record number of commendations were received during the year for our customer service.

We continued to participate in environmental and community activities in 2006. The Smart Power and Green Lamma Green campaigns which are ongoing projects aimed at promoting conservation and energy efficiency continued to be well received with high participation rates. In February 2006, we launched the Hongkong Electric Clean Energy Fund to coincide with the commissioning of Lamma Winds, our wind turbine on Lamma Island, in order to increase public awareness of renewable energy. We also continued to be active in the community with our 700 strong Hongkong Electric volunteers team.

International Operations

Our Australian electricity distribution businesses in South Australia and Victoria achieved good financial and operational performance in 2006 with the businesses exceeding financial targets. Revenue and demand in both the businesses increased in 2006.

Northern Gas Networks in which we have a 19.9% interest operates a gas distribution network in northern England. The results of Northern Gas were in line with our forecast with increased dividends being paid in 2006.

In Thailand, construction on the 1,400 MW gas-fired power station in Ratchaburi province in which we have a 25% interest is well underway and commissioning of the power station is scheduled for 2008.

Future Development of the Electricity Market in Hong Kong

In 2006, the Hong Kong Government concluded its consultation process on the future development of the electricity market in Hong Kong. There was a general consensus arising from that consultation process that the existing scheme of control regulatory framework should be continued and that reliability and safety of supply were the most important factors and should be the key consideration in the future development of the electricity market. We stated in our consultation submission that the existing scheme of control and the permitted return under that scheme have ensured that the necessary investment has been made in the generating capacity and transmission and distribution network to achieve the high degree of stability and reliability that we have in Hong Kong. We also stated that the return in any new regulatory arrangement must be sufficient to incentivise investment in Hong Kong's electricity infrastructure so as not to jeopardise the existing high level of quality and reliability of supply. Additionally, the period of any new regulatory arrangement must be sufficiently long bearing in mind the long-term nature of investment in electricity infrastructure where asset lives often exceed 30 years. We also indicated that the Government must make clear its environmental policy for the future in order to enable us to undertake the necessary long-term planning required to meet both emission and fuel supply requirements.

We have now commenced our discussions with the Government on the regulatory framework following the expiry of the scheme of control in 2008. Any post 2008 regulatory framework must recognise the investment made by our shareholders in Hong Kong's electricity infrastructure which has enabled Hong Kong to enjoy the high stability and reliability in electricity supply that it has today and also the vital interest of our customers in the continued security and reliability of electricity supply.

Outlook

In Hong Kong, we expect the trend of low sales growth in electricity to continue in 2007. High coal and natural gas prices are also expected to continue to put pressure on fuel costs. We will move forward with our emission reduction initiatives at the Lamma Power Station. Following the commissioning of Unit 9, gas is expected to fuel 15% of the electricity generated by the Lamma Power Station in 2007. Work is underway to retrofit two existing coal-fired units with flue gas desulphurisation plants and low nitrogen oxide burners. Following completion of these works, which is scheduled for 2010, more than 90% of the electricity generated at the Lamma Power Station will be generated by gas and by coal-fired units fitted with flue gas desulphurisers and low nitrogen oxide burners.

Internationally, we will continue to look for investment opportunities in order to increase earnings and to reduce the proportion of our earnings derived from the electricity operations in Hong Kong.

I would like to take this opportunity to thank the Board of Directors for their guidance during the year and the management and staff for their commitment and hard work in 2006.

Canning Fok Kin-ning

Chairman
Hong Kong, 8th March 2007