

Chairman's Statement

"I am unreservedly proud of the **quality** of the service provided by CLP Power to electricity customers"

The Hon. Sir Michael Kadoorie, Chairman



Dear Shareholders,

This Annual Report presents a solid performance by the CLP Group during 2011. In line with our move towards integrated reporting, the social and environmental aspects of that performance are described both in this Annual Report and, more fully, in our online Sustainability Report. Our financial performance, which is explained in detail in the Financial Review and in the Financial Statements which form part of this Annual Report, showed an improvement in Group operating earnings to HK\$10,312 million, a 12.7% increase compared to HK\$9,148 million in 2010. Group total earnings, including non-recurring items at HK\$9,288 million, were 10.1% lower than those of the previous year. 🌱

Shareholders will particularly note the substantial growth in operating earnings from TRUenergy in Australia, following the acquisition in early 2011 of the EnergyAustralia retail business and the Delta Western GenTrader contracts, based in NSW. Overall, earnings from our activities outside Hong Kong contributed HK\$3,711 million to operating earnings. This was the largest ever contribution from those activities, both in absolute terms and as a proportion of Group earnings. Even so, the Hong Kong electricity business remained the largest single source of earnings for CLP and its shareholders.

Serving Hong Kong

Rather than giving a broad overview of the Group's activities, it has been my practice in my Chairman's Statement in recent years to focus on specific issues which I consider are of particular importance or concern to our shareholders. This year, I wish to continue this practice by discussing issues arising from the tariff increase which CLP Power announced in December 2011 for our Hong Kong electricity customers, with effect from the beginning of this year. This is an appropriate subject for detailed discussion since this business contributes substantially towards the continued delivery of shareholder value. Moreover, shareholders, many of whom live in Hong Kong, and other stakeholders will have already seen the extensive press coverage of the tariff issue. This has included much criticism of the justification for the tariff increase and of the performance by CLP of its responsibilities to Hong Kong as the provider of an essential service, as well as numerous comments on future regulatory change.

At the outset, I wish to emphasise that we can have no objection to the close, continuing and critical scrutiny to which our Hong Kong electricity business is subject. This is both inevitable and proper, given that we are the sole supplier of an essential public service to 80% of Hong Kong's population. It is also not surprising that some of the criticism we received in the political domain and in the press is, in our view, misinformed, incorrect and unjustified. That, after all, is part and parcel of free speech on public issues. At the same time, I do not think that any fair-minded person would deny me an opportunity to express my views on such matters, on behalf of my colleagues, our Board and our shareholders – and to do so in the frank and straightforward manner which these issues deserve.

Let me start by saying that I am unreservedly proud of the quality of the service provided by CLP Power to electricity customers in Kowloon and the New Territories. For over a century, we have had the privilege of serving our community. Throughout those many decades, which have included troubled and turbulent times, CLP has faithfully discharged its responsibilities to provide Hong Kong with the electricity needed to power its remarkable social and economic development.

In the past ten years alone, CLP's shareholders and lenders have invested almost HK\$70 billion in ensuring that Hong Kong has the electricity infrastructure it needs. All of those investments were aimed at providing an improved service – and all of them were made with the prior approval of the Hong Kong Government. By any of the characteristics by which the quality of an electricity supply should be measured, CLP delivers excellence to our community:

- Reliability – the reliability of our electricity supply is amongst the best of any city in the world – more reliable than New York, London and Sydney and greatly superior to that delivered to customers in other major cities of China such as Beijing, Shanghai and Shenzhen;
- Cost-competitiveness – even after the tariff increases which took effect in January 2012, CLP's tariffs, on average, are amongst the most competitive in the world. For example, within our region, they are lower than those of Tokyo, Sydney and Manila. What is more, CLP achieves these tariff levels without receiving any subsidies or support from taxpayers, whether direct or indirect such as in the form of property rights;
- Customer service – our customer service levels meet those of any developed economy and, in some instances, rank amongst the very best in the world. For example, CLP's service quality recently led to Hong Kong being ranked fourth out of 183 economies in the ease and speed by which electricity is connected to newly-constructed buildings;
- Environmental performance – with full operation of the emissions control facilities at Castle Peak Power Station in 2011, the Station now removes 99.76% of Respirable Suspended Particulates (RSP), as well as over 90% and 50% of emissions of Sulphur Dioxide (SO₂) and Nitrogen Oxide (NO_x) respectively – making this amongst the cleanest coal-fired power stations in the world. This is just a recent example of the sustained effort made by CLP to reduce emissions from the generating capacity which serves our customers. Our CO₂ emissions intensity has also seen massive reductions. Since 1990 total emissions of CO₂ from power generated to meet our customers' needs has only increased by 13%, even though there was an 82% increase in electricity demand over the same period; and
- Affordability – since 1991 CLP's average tariffs have risen by 64%. During the same period, Hong Kong's GDP rose by 170% and average household incomes rose by over 100%. In real terms, that is to say taking into account inflation, the price for electricity paid by our customers is unchanged since 1991. In other words, electricity has become more, not less, affordable – as is also demonstrated by the ongoing rise in electricity demand.

I would like to think that these figures speak for themselves about the quality of the electricity service which CLP provides. However, it is clear that they do not. There may be a number of reasons for this, some particular to Hong Kong's current political and social climate and some particular to the electricity industry. In many respects, excellence in electricity supply is something which Hong Kong people take for granted – rightly so, since our citizens need and deserve quality in the provision of this essential service. In the case of CLP, much of the service we provide and the investments which lie behind it are "invisible" to the public – our connection with customers may often be only a plug in a wall and a bi-monthly bill. In addition, for reasons which others may be able to comment on with greater insight, rises in the cost of public services which elsewhere would be unremarkable, and unremarked upon, have become issues of major political, press and public criticism and controversy in Hong Kong – as our counterparts in the provision of other public services, including utilities and transport, have similarly experienced. It is also noteworthy that the SAR Government has found difficulty, or has perhaps been reluctant, in explaining its policies for the provision of public services, including electricity, the choices involved in its policy decisions, the consequences for service providers and the resulting cost increases for consumers. This leads me to the key message which I wish to convey in this Chairman's Statement. This is one of "Choices and Balance".

Choices

Choices about Hong Kong's electricity supply are made by the community and by the SAR Government, speaking and acting on behalf of the community. Those choices should aim to strike society's preferred balance between cost, supply reliability and security, customer service and environmental performance.

Historically, Hong Kong placed great weight on the rapid expansion of generating, transmission and distribution infrastructure in order to meet the rapidly growing demand for electricity without jeopardising supply reliability. In recent times, Government, with the support of our legislature, has chosen to move towards cleaner generation and to place greater weight on improvement in environmental performance. This choice has direct consequence in terms of the need for major investment in new generating capacity to replace existing coal-fired generation and massive increases in fuel costs. The latter arises because gas is a considerably more expensive fuel than coal and gas prices have moved sharply upwards in recent years, given that Asian gas prices are generally linked to oil prices.

Let me give a specific example of a choice which Government has made, and the consequences. In August 2008 the SAR Government entered into the Memorandum of Understanding (MOU) with the National Energy Administration regarding Hong Kong's future energy supply. In so doing, the SAR Government chose to look towards the Mainland for long-term gas supply and to avoid the potential environmental impact associated with the development of a Liquefied Natural Gas (LNG) terminal on the South Soko Islands within Hong Kong waters. At the same time, that choice had consequences in reducing Hong Kong's options and ability to directly access potentially cost-competitive gas supplies from the international gas market, as well as upon Hong Kong's potential to become a centre for design, engineering and operating expertise in LNG terminals.

As part of the policy orientation towards cleaner generation, the SAR Government has also been setting increasingly stringent emission caps on our Hong Kong generating capacity. Such a choice is entirely understandable and legitimate. All of us, as Hong Kong citizens, myself included, would greatly welcome a significant improvement in local air quality.

Government's choice leads to more gas-fired generation and has already required the investment of about HK\$9 billion in further emissions reduction plant for coal-fired generation at Castle Peak. These environmental improvements must be paid for. Let me take the increased use of gas as an example. The cost of fuel used to generate electricity for our Hong Kong customers is passed through to customers under CLP's fuel clause charge. CLP and its shareholders make no profit on fuel. At present, the amount charged under the fuel clause is set at a level which recovers only the costs of coal purchases and the cheap Yacheng gas (contracted for 20 years ago, and with declining production due to field depletion). In fact, over the past five years, the amounts charged to customers have not even been sufficient to cover the lower, historic fuel costs. By the end of 2012, unless the cost of fuel is more fully borne by those customers who benefit from the electricity which it generates, CLP's customers would have paid about HK\$800 million less than the actual costs of the fuel used to supply their electricity in the past.

As a result of the gas supply agreements with Mainland suppliers, required by the MOU signed by the SAR Government, we estimate that, by 2015, fuel costs alone will increase by around 250% from current levels. This is the equivalent of about a 40% increase in overall cost to the consumer and will require regular and substantial tariff increases over the intervening period. I emphasise, once again, that this increase represents the price of gas paid to Mainland suppliers – none of this increase is for the benefit of CLP's shareholders.

I might also add, in anticipation of the point being made, that none of this increase is attributable to the SoC. Irrespective of whatever regulatory regime is in place, the costs of fuel must ultimately be paid by electricity customers. Singapore has already transitioned towards predominantly gas-fired generation. Singapore has competition between differing generating companies. It might, therefore, be regarded by some as a model towards which Hong Kong might migrate over time. And yet, a typical Singapore resident can face electricity bills which are over 80% higher than those paid by his or her counterparts in Hong Kong.

In its public consultation on Hong Kong's Climate Change Strategy and Action Agenda the Government is contemplating new policy developments to set a fuel mix target by 2020 for the power sector of 50% nuclear, 40% gas, 3 to 4% renewable energy and not more than 10% coal. The environmental benefits which this might deliver in terms of tackling climate change will come at substantial additional costs for fuel – above and beyond those which will already arise by 2015 due to higher gas costs. These increased costs will be reflected in sustained upwards tariff pressure on customers through to the end of the decade.

Balance

I explained earlier that CLP currently delivers an electricity supply which is first-class by any meaningful measures. Those who represent our society have already spoken for and made changes which are leading to a major transformation of Hong Kong's electricity sector and are contemplating further changes. These will deliver improved environmental performance, but will also have other consequences, notably in the form of the increased costs of delivering to our customers an electricity service which reflects the new balance which has been struck. A proper debate about the future of our industry involves not just discussion about the choices which can be made, but an honest and informed discussion about their consequences. A much more open debate needs to take place within Government, the political community and society as a whole to develop a sound energy policy which allows private sector investment to deliver an electricity supply and infrastructure whose qualities correspond to the wishes of our citizens. A sound energy policy will also promote the wise and sustainable use of energy in the interests of both cost-efficiency and the environment – an outcome from which all of us will benefit and to which all of us can contribute.

The choices to be made on energy policy, such as where the balance is to be struck between supply reliability, lower emissions and higher tariffs are not easy. They should be made by Government and society – not CLP. Our own role is two-fold. First, we welcome any opportunity to contribute an informed, authoritative and reasoned voice to the public debate on choices about Hong Kong's electricity service and their consequences. Secondly, and this is where CLP can truly add value to our community, we will implement whatever choices are made as effectively, responsibly and efficiently as possible – as we have for over 100 years.

The Hon. Sir Michael Kadoorie

Hong Kong, 27 February 2012



Opening "A Partnership with the People: Kadoorie Agricultural Aid Association and Post-war Agricultural Hong Kong" – an exhibition at the Hong Kong Museum of History