CEO's Strategic Review

In December 2012, as in each year, I presented to our Board the CLP Group Business Plan and Budget for the coming five years, in this case the period from 2013 to 2017. In this Strategic Review I share the key messages from that briefing with shareholders so that, in exercising their rights and pursuing their interests as shareholders, they have a similar overview of CLP's strategy, performance and prospects to that of the Board in its stewardship of the Company's affairs.

Our Strategy

CLP's business model is simple. CLP is an investor and operator in the energy sector of the Asia-Pacific region. CLP does not intend to conduct any other activity, nor extend our business beyond that region. Our strategy is equally straightforward:

- a strong focus on continually enhancing the performance of our Hong Kong electricity business, which will remain at the core of the CLP Group's activities for the foreseeable future; and
- outside Hong Kong, a flexible, market-by-market approach, with a focus on a balanced portfolio which reflects our long-term move towards a low-carbon business.

Our present and future direction is aligned with this business model and fundamental strategic precepts. We have consistently disclosed to shareholders and other stakeholders the progress CLP has made in realising its strategy. We have explained that this strategy points towards a "2020 Vision" of CLP as a diversified electricity company which:

- maintains its base and core operating business in Hong Kong, subject to the opportunities and challenges offered by any changing electricity regulatory framework;
- holds a significant stake in a leading listed Australian energy supplier, following industry consolidation;
- is the controlling shareholder of a listed energy company in India and Southeast Asia;
- has a significant, but minority, stake in nuclear energy in Southern China and is looking to exploit this in other Asian markets;
- invests in and operates, if available, transmission and distribution assets in India and in the Chinese mainland;
- has largely exited minority positions in conventional coal-fired generation in the Chinese mainland; and
- is one of Asia's largest investors in clean and renewable energy.

CLP remains on track towards this "2020 Vision", except for the aspiration to become the controlling shareholder of a listed energy company in Southeast Asia. Having regard to a number of factors, including capital constraints, the availability of investments elsewhere and the lack of opportunities in Southeast Asian energy markets for private sector participants such as CLP, we no longer consider that this is an objective to which CLP should aspire. We have not yet advanced our presence in the transmission and distribution sectors of the power industry in India and the Chinese mainland. This is due to limited scope for private sector investment in these sectors. If these markets do open up for investment on suitable terms, we have the capability to make and manage such investments.

We are also on course to deliver on our Climate Vision 2050, our commitment made in 2007 to make deep reductions in the carbon emissions intensity of our power generation capacity and to embark on a wide range of actions and other initiatives to reduce the carbon footprint of our business and to help stakeholders reduce their own impact.

2012

Implicit in CLP's strategy are two judgments. The first is that the slowdown in growth in electricity demand in Hong Kong, coupled with increasing regulatory risk, means that it is prudent and in the long-term interests of shareholders, to diversify CLP's business beyond reliance on a single business in Hong Kong. Secondly, that CLP's core operating, commercial and financial capabilities permit CLP, over time, to invest effectively and profitably in markets in Asia Pacific beyond Hong Kong, even if those markets may be more volatile than our existing Hong Kong electricity business.

CLP's performance in 2012 reflected both these identified risks, namely regulatory pressure in Hong Kong and the unpredictability of earnings elsewhere. For the Hong Kong business, CLP has always recognised the priority to be given to the ongoing management of the interface with the HKSAR Government, both to protect shareholders' interests under the current SoC and to position the business for any changes that might occur if the initial term of the SoC ends in 2018. The controversy associated with the implementation of the January 2012 tariff increase, the intense political, media and public criticism to which CLP was subject and the close and critical scrutiny of CLP's position as the sole supplier of an essential public service in Kowloon and the New Territories was a prominent aspect of our Hong Kong business in 2012.

The volatility and unpredictability of earnings from our investments outside Hong Kong was also illustrated in 2012. During 2011, our non-Hong Kong businesses contributed 34.3% of Group operating earnings, before unallocated expenses, HK$3,711 million out of HK$10,831 million. This was the highest contribution that those non-Hong Kong businesses have ever made to Group operating earnings. In contrast, during 2012, the earnings from CLP's non-Hong Kong businesses were only HK$2,565 million, a decrease of 30.9% compared to the corresponding period in 2011 and constituting only 25.7% of Group operating earnings, before unallocated expenses, for 2012. The decline in operating earnings outside Hong Kong was further exacerbated by the impact on total earnings of both the Yallourn mine flooding, HK$790 million, and the impairment of our investment at Jhajjar and Boxing Biomass of HK$409 million.

2012 has, therefore, proved to be a difficult year for the CLP Group with total operating earnings of HK$9,406 million, 8.8% below those of 2011. The major challenges which CLP has faced in 2012 include:

- a difficult political and regulatory environment in Hong Kong;
- the negative effect on EnergyAustralia of an overall slowdown in electricity demand growth in the National Electricity Market leading to suppressed wholesale energy prices;
- operational and financial problems at Jhajjar, principally the result of insufficient, erratic and poor quality of coal supply from Coal India Limited (CIL);
- notwithstanding improved performance, slower than expected delivery of earnings from CLP India's wind portfolio; and
- a delay in the approval of CLP's proposed investment in the Yangjiang nuclear plant, as well as the implications of the Mainland authorities' assessment and implementation of the outcome of the National Nuclear Safety Review, following the Fukushima nuclear accident in March 2011.

CLP Management has already given clear priority to addressing the challenges that have weighed on the Group during 2012. One of the underlying themes of this Annual Report is the progress which CLP will continue to make in addressing the issues, so as to deliver the upwards earnings trajectory which our shareholders expect of us.

Looking Ahead

In the following paragraphs I offer an outline of the key factors which may impact, positively or negatively, the performance of the CLP Group's various business activities over the coming years.

Hong Kong

As noted above, the ongoing management of the interface with our regulator, the HKSAR Government, is a priority for this business. The experience of recent years, especially around the January 2012 tariff increase, has demonstrated the extent to which decision-making related to the Hong Kong power sector rests not merely with the HKSAR Government, but is strongly influenced by others, such as legislators, the media and concern groups. One implication of this for CLP is that management of the relationship with the Government encompasses the broader task of the effective establishment and ongoing maintenance of relationships with all the stakeholders whose views influence Government policy.

CLP has already reinforced the resources devoted to stakeholder management in Hong Kong. The effectiveness of this work is particularly important for the successful outcome of a number of issues, including:

- Tariff management, including increases to basic tariff and the fuel clause charge. CLP will do everything possible to control costs and enhance business efficiency. However, further tariff increases are inevitable due to rising fuel costs and to avoid further substantial increase in the deficit in the fuel clause account (which arises when customers are billed less than the actual cost of the fuel paid by CLP to generate the electricity they consume).
- The Development Plan 2014-2018 which will set out CLP's approved capital expenditure over the remainder

of the current SoC. We expect close scrutiny of planned capital expenditure during the Development Plan period. As remarked in the Chairman's Statement, in this Annual Report, whilst Government will place significant weight on the tariff implications of additional investment, it is important that due regard is paid to system and operational needs, benefits or consequences.

- Interim Review. The current SoC Agreement provides for an Interim Review in 2013. Under this Review, changes to the SoC can be made by mutual agreement between CLP and Government. As with previous interim reviews, CLP will approach any discussions with Government in a constructive and open-minded spirit. We will not be ready to accept amendments which are unfair or one-sided and which run counter to the fundamental character of the SoC Agreement as a binding contract between its parties.
- The Government-to-Government MOU on Energy Cooperation signed in 2008 provided the basis on which CLP must enter into long-term commercial agreements and invest in the necessary infrastructure, within both the HKSAR and Guangdong Province, to support Hong Kong's transition to cleaner energy. Those agreements and the associated investments will need approval from the SAR Government.
- Air Quality. Government policy on improving local air quality will impact the emissions control targets set for power generation in Hong Kong, the fuel mix required to meet those targets and the capital expenditure on additional, replacement or improved generating capacity.

Aside from the effective management of the interface with the SAR Government, CLP's "social franchise" in Hong Kong depends on the continued quality of our operations and the recognition by Government and the community of CLP's performance on tariff, reliability, environmental impact and customer service levels. Supported by ongoing, targeted capital and operating expenditure we will improve the quality of our electricity service, wherever possible.

In March 2012, CLP announced that negotiations were taking place with ExxonMobil for the acquisition by CLP, in joint venture with China Southern Grid (CSG), of the entirety of ExxonMobil's 60% shareholding in CAPCO. The negotiations with ExxonMobil have been protracted and there has been a considerable gap between CLP/CSG and ExxonMobil on the valuation and terms of any such acquisition. At present I can add nothing to the announcement previously made nor offer any indication of whether or when an agreement might be reached with ExxonMobil. I would, nonetheless, emphasise that if any agreement did materialise, the terms of this will be openly disclosed to shareholders and must be such that the Board and I are satisfied will deliver future value to them.

Australia

It was an exceptionally challenging business environment, with a number of external market factors influencing the business during 2012. These included the introduction of a carbon tax, reduced wholesale energy prices, consumer concern about rising energy prices, declining energy demand and a significant downward revision of future demand projections, all combined with continuing high retail competition in our key markets and regulatory uncertainty around price setting by NSW and Queensland. These factors impacted the industry as a whole, providing difficult trading conditions for ourselves and our major competitors alike.

Against this background, we focused on the fundamentals of the business while positioning ourselves to meet the future needs of our customers. We rebranded the business, implemented a new retail billing system, introduced new retail products, defended our market share and optimised the profitability of generation across our portfolio. We also continued to develop and deliver strong advocacy positions particularly around gas market transparency and retail price regulation. We responded with commitment, resourcefulness and ingenuity when faced with the breach of the Morwell River Diversion which temporarily disrupted operations at our Yallourn Power Station.

EnergyAustralia is placing particular emphasis on an ongoing programme of operational improvements, including:

- a comprehensive review of costs and processes and a series of management initiatives intended to improve business performance across the portfolio;
- managing the implications of reducing growth in energy demand leading to suppressed wholesale prices. This requires EnergyAustralia to pursue strategies which optimise the manner in which the availability of its generating capacity and energy trading activities are conducted;
- completion of the long-term remediation works at Yallourn, in a cost-effective and durable manner, following the Morwell River Diversion failure in June 2012;
- reducing delays in customer billing and collections;
- maintaining retail customer accounts in a competitive market while improving efficiency; and
- completion of the integration of the retail customer base acquired in the NSW privatisation with those of the legacy TRUenergy business. This includes the roll-off in early 2014 of the Transition Services Agreement (TSA) (under which Ausgrid, the NSW State-owned entity and previous owner of the retail business, continues to provide customer support) which should lead to significant reductions in the cost to serve the NSW retail customers.

Whilst no decision has been taken regarding the principle, timing or terms of any listing of EnergyAustralia, this was an option to which we gave serious consideration in 2012. We decided not to proceed as we believe that with the operational imperatives and general economic environment described above, the current earnings performance of the business falls short of the level which we believe the company can deliver on a longer term and sustainable basis. This suggested that a listing of the EnergyAustralia business in 2012 was unlikely to deliver full value to CLP's shareholders from their investment in Australia.

In the meantime, Management continues to prepare EnergyAustralia for an IPO, including the implementation of governance arrangements, such as the appointment to the Board of EnergyAustralia in October 2012 of an independent Chairman and a majority of independent directors, as would be required upon listing. The steps required to bring EnergyAustralia to IPO-readiness are in any event those which will be in the interests of CLP's shareholders, irrespective of whether and when the IPO was undertaken.

In the short term I do not envisage substantial investment in new assets or projects in Australia, with the exception of a limited amount of wind generating capacity and possible participation in the planned privatisation by the NSW Government of its remaining interests in State-owned power generation assets. We have strengthened the senior management resources and organisational capability of EnergyAustralia in the past two years. The organisation has the capability and clarity of focus to deliver improved performance.

Chinese Mainland

CLP's investments in conventional and renewable energy in the Chinese mainland performed well in 2012. This reflects the continuation of CLP's "niche" strategy of selective investments in coal-fired generation and renewable energy in China, accompanied by the divestment of minority stakes in joint ventures (predominantly coal-fired generation) where CLP has no significant measure of control and growth prospects appear limited. The timing of any such divestments is at our option and will be dependent on market conditions, as evidenced by satisfactory prices and terms.

The major investment which I foresee in the Mainland is the commencement and commissioning of an additional 1,320MW generating capacity at Fangchenggang II (in which CLP will hold a 70% interest). Fangchenggang I has proved a successful investment. Whilst the investment case of Fangchenggang II must be judged on its own merits, the performance of Fangchenggang I provides grounds for confidence in this expansion project, even taking into account the possibility of lower utilisation hours than has previously been the case at Fangchenggang I.

We aim for steady growth in CLP's wholly-owned wind energy portfolio. This will be characterised by a broad focus on projects in Southern China. Compared to Inner Mongolia and other northern provinces, these are less affected by grid restrictions, even if the wind resource may be inferior. With

Fangchenggang Power Station Phase I – a base for further expansion the exception of a 45% shareholding in a 49.5MW project at Laizhou Phase II, CLP does not envisage additional investment in wind energy projects which are not wholly-owned.

CLP's move towards renewable energy will also include majority-owned solar energy projects, where CLP envisages exploiting the opportunity, which may be temporary, to benefit from the combination of reduced solar panel prices and tariff support that has not yet been adjusted downwards in line with the fall in project costs. Further investment in small to medium-size hydro projects in China has been slowed by a tariff regime which is not supportive of such projects, relative to other renewable energy sources. CLP's successful experience at Huaiji and Jiangbian would allow us to pursue such projects if they came forward.

Nuclear

CLP has reached an agreement in principle with CGNPC for the acquisition of a 17% shareholding in the Yangjiang Nuclear Power Station. However, the completion of the six units at Yangjiang was delayed, awaiting the completion of the National Comprehensive Nuclear Safety Review Report following the Fukushima accident. Following the recent approvals by the State Council of the Plans for Nuclear Power Safety and Nuclear Power Development (2011–20), CLP is assessing the overall cost impact of possible design changes for the Yangjiang Project and the technology choice for Units 5 and 6 before proceeding with the regulatory approval process to complete the acquisition of the 17% shareholding in Yangjiang. Although our decision remains open, my current expectation is that CLP's review of project costs, equipment choices and investment returns would confirm our in-principle decision to invest in Yangjiang, subject to the necessary approvals for that investment being forthcoming.

India

The poor operating and financial performance of the newly commissioned Jhajjar Power Station remains the major priority for CLP India. Each link in the project chain presents substantial challenges, be it:

- the adequacy, reliability and quality of coal supplied by CIL;
- the effect the poor quality coal has on the reliable and efficient operation of the plant;
- the credit-worthiness of the Haryana State off-takers and their willingness to honour their contractual obligations in the face of the impact, on both cost and reliability, of the inadequate coal deliveries to Jhajjar; and
- the resilience of the project finance arrangements in light of the poor financial performance of Jhajjar following commissioning.

All these challenges result, directly or indirectly, from the problems of coal supply. There is no single step or "silver bullet" which can rapidly and effectively cure the issues faced by this project. However, a series of measures are already underway, including the use of imported coal (initially of an amount representing 15% of plant requirements, with in-principle support obtained on 16 January 2013 and since

Coal Train approaching Jhajjar – we need five to six each day confirmed in a meeting with the Chief Minister of Haryana, to increase this in the Indian fiscal year 1 April 2013 to 31 March 2014) and improvements to the coal handling equipment.

The technical performance of the plant has improved tremendously, despite a commissioning period which was badly disrupted by coal shortage. Technical plant availability in January 2013 was 96.7% – if coal is delivered, we will generate electricity reliably and to the full capacity of the power station. Through intensive effort, CLP expects an improvement in the financial and operating performance of Jhajjar over the next 6 to 18 months, largely attributable to slow but steady increases to the level of coal supplied to Jhajjar from both domestic and international sources. It may, however, take two to three years before Jhajjar reaches a point where its operations might be regarded as stable and predictable and on track to deliver returns close to the investment case. In all the circumstances we have considered it appropriate to make a provision for Jhajjar in this year's financial statements in the amount of HK$350 million (HK$315 million after tax). Nonetheless, the fundamentals of the project are good. We built the plant well and will operate it efficiently, Haryana desperately needs electricity and Jhajjar is a highly-competitive electricity generator. In the end, these fundamentals will play out to a positive outcome, but it will take time, effort, resources and patience to arrive there. The problems at Jhajjar are an example of those afflicting the coal-fired generation sector in India as a whole. We have pressed the Indian authorities at all levels to intervene to ensure the proper implementation of national and state energy policies. As part of the Association of Power Producers, I have met the Prime Minister and expressed our concerns directly to him and his ministerial colleagues.

CLP's longstanding investment in the 655MW gas-fired power station at Paguthan continues to perform satisfactorily. Under the current Power Purchase Agreement (PPA), a substantial measure of protection is afforded against difficulties in both the volume and pricing of gas supplies. Efforts have been underway for some years to obtain secure, stable and competitively-priced gas for Paguthan, failing which the economic performance of the plant risks to be adversely affected upon the conclusion of the existing PPA in 2018.

Against this background, I do not contemplate further investment by CLP India in thermal power generation for the time being. Our focus is on improving the performance of Jhajjar and securing the longer-term economic prospects of Paguthan.

New investment in India will centre on continued growth of CLP's wind energy portfolio. Some solar and hydro investments may be contemplated, having regard to the quality of the relevant projects, in the interests of a balanced renewable energy portfolio. With respect to wind, the performance of certain of the earlier wind energy investments made by CLP was unsatisfactory, relative to the original investment case. This was primarily due to shortcomings in the assessment of the local wind resources at the sites of certain of our earlier projects, as well as wind conditions which appear to have been inferior to the long-term average (particularly having regard to the substantial impact of seasonal monsoon wind conditions on annual wind resources). However, the financial performance of the Indian wind portfolio has been improving as a result of:

- improved wind resource measurement of new projects;
- higher output as a result of a series of improvements we have made in our oversight and active management of the operations and maintenance of the wind turbines by the suppliers; and
- wind resources which have indicated some movement back to forecast levels.

These positive developments have encouraged us to look for further growth in CLP India's wind energy investments, possibly around 200 to 300MW per year. The pace of growth may vary in light of the ongoing performance of the wind energy portfolio as a whole, the maintenance of supportive tariff and regulatory frameworks, the creditworthiness of state off-takers and the overall demands and priorities of capital allocation across the CLP Group.

Southeast Asia and Taiwan

We do not contemplate additional investment in these markets, other than the possibility of one or both of the greenfield coal-fired power station development projects in Vietnam coming to fruition. Over the next 12 to 18 months, these projects, which have been under development for a number of years, may advance to a point where CLP will have to decide whether to proceed or to monetise the value of the development work which has been completed.

CLP's remaining 20% stake in the Ho-Ping Power Station in Taiwan might be regarded as a legacy investment, in the sense of being a minority shareholding with little expansion potential. However, Ho-Ping has provided a regular and stable contribution to Group earnings, whilst making few demands on management time and resources.

Funding

Over the past five years, CLP has invested substantially in the implementation of its strategy. Whilst our balance sheet remained healthy, we needed to consider options to support the financing requirements of our business in light of:

- investment opportunities across our various business streams in line with strategy;
- the maintenance of a strong and stable dividend;
- safeguarding our good investment credit rating; and
- presenting a prudent capital position.

This led to a decision to proceed with a placement in December 2012 of new shares representing an additional 5% of CLP's existing issued share capital. The net proceeds from the placement of HK$7.56 billion will be used for expected investment needs across CLP's business, notably ongoing investment in the Hong Kong electricity business, such as in infrastructure related to gas supply from the Mainland and additional generating capacity in those markets where CLP is already present, such as the expansion of Fangchenggang and development of renewable energy projects.

Controlling Costs

I am conscious of the contribution that careful control of costs can make to increased operating earnings. In recent years, in line with the growing maturity and capability of the individual business units, the Group has devolved functional responsibilities and associated resources away from the centre towards the business units. I expect this trend to continue. In addition to greater autonomy at business unit level, this should contribute to reducing Group level costs and unallocated expenses.

Head Office Redevelopment

I am also aware of the importance of realising the potential value of assets within our portfolio and optimising the benefit of under-utilised assets. The move of our Hong Kong head office in 2012 is an example of this. In 2011 the Town Planning Board approved a modified scheme for CLP to develop part of its head office at Argyle Street, Kowloon for residential purposes, whilst preserving the Clock Tower building for community use. Demolition work on part of the site was completed in early February 2013. Whilst we will be starting foundation works for the residential development during 2013, there is not yet a timetable for the development and the receipt of sale proceeds. Discussions with the relevant Government departments on issues related to lease modification and possible premium have been difficult and slow. This experience reflects the challenges to the development of privately-owned sites in Hong Kong which appear to be faced by the property development sector as a whole. The proposals CLP has submitted to the Government, which were the subject of the Town Planning Board's approval, represent a balanced outcome to the legitimate interest of CLP's shareholders in the development of the site and the community's interest, supported by Government policy, in the preservation of Hong Kong's built heritage, in the form of the Clock Tower. We look for substantial progress on this over the next 12 months.

The Argyle Street site has been available for redevelopment since May 2012 when we relocated our head office to premises in Hung Hom. These premises were formerly part of an under-performing shopping mall in which CLP already held a 50% interest in joint venture with Cheung Kong. CLP has now taken over the top two floors of the mall and converted these to office use – a highly cost-effective use of an otherwise under-employed asset.

Delivering Growth

I have been CEO of the CLP Group since 2000. Experience has taught me to be realistic about the challenges we face, but confident in our ability to overcome these and to deliver on our vision to be the leading responsible energy provider in the Asia-Pacific region, from one generation to the next. Whilst the past year was not easy, the business which I described to the Board in December, and which I have presented to you in this Strategic Review, is one which is in good shape, possesses a healthy balance sheet and is highly capable of delivering growth in earnings through the years ahead in line with a strategy which is clear and widely disclosed.

Andrew Brandler

Andrew Brandler
Hong Kong, 25 February 2013