

RISK FACTORS

Risks and uncertainties can affect the Group's business, financial condition, operating results or growth prospects leading to a divergence from expected or historical results. Key risk factors affecting the Group are outlined below. In dealing with these, the Group remains in touch with its stakeholders with the aim of understanding and addressing their concerns.

These factors are not exhaustive or comprehensive, and there may be other risks in addition to those shown below which are not known to the Group or which may not be material now but could become material in the future.

GLOBAL AND HONG KONG ECONOMIC ENVIRONMENT

Global economic growth remains slow with subdued demand in major economies. The outcomes of the UK referendum and the US presidential election heightened uncertainties in the world economy and global financial market. Growth in the Hong Kong economy remains modest with weak exports, slow retail sales and declines in visitor arrivals.

The prevailing global uncertainty may materially and adversely affect the business of customers or potential customers, or cause a slowdown in economic activities in Hong Kong, which, in turn, may lead to a lower demand for electricity and related services in Hong Kong. This may adversely affect the Group's financial position, potential income, asset value and liabilities.

To address uncertainty in the global and Hong Kong economies, the Group pursues prudent and pragmatic strategies in financial management and capital investment. The Group also strives for efficiency and cost effectiveness in all aspects of its operations to enhance its financial performance.

INTEREST RATES AND CURRENCY MARKETS

The Group is exposed to interest rate risk on its interest-bearing assets and liabilities. The US Federal Reserve ("FED") raised interest rate in its December 2016 FOMC meeting, presented a more hawkish view than anticipated and projected to have three hikes in 2017 although the new US presidency might create uncertainty on the deliberation of the targeted increases. The Group is exposed to currency risk that mainly arises from the import of fuel and capital equipment, and from its debt issuances in capital markets.

The Group's treasury policy guides the measures it undertakes to manage these exposures. Details of the Group's current practices to manage interest rate and currency risks are in the Financial Review on pages 55 to 57.

ELECTRICITY MARKET

The operations of the Group's electricity business in Hong Kong are subject to a Scheme of Control Agreement ("SCA") with the Government, which provides for a permitted level of earnings based principally on average net fixed assets for electricity-related operations.

The current SCA was renewed in 2008 for a term of ten years commencing 1 January 2009 with an option for the Government to extend it for a further term of five years. The implementation of the 2014-2018 Development Plan under the SCA, the structure and regulation of the power industry in Hong Kong upon the expiry of the current SCA, and the Government's policies on air quality, climate change mitigation, fuel mix and electricity market competition for the medium to long term are all factors affecting the Group's results and growth.

The Group has established a mechanism to review these factors on a regular basis and continuously engages in discussions with the Environment Bureau as well as various stakeholders on electricity market and regulatory issues.

HEALTH AND SAFETY

The nature of the Group's operations exposes it to a range of health and safety risks.

Major health and safety incidents resulting in fatalities or injuries to members of the public or employees could have significant consequences. These may include widespread distress and harm or significant disruption to the Group's operations, and could result in regulatory action, legal liability, material costs and damage to the Group's reputation.

The Group has in place a Health and Safety Management System to manage its exposure and protect its employees, customers, contractors and the public by conducting its business in a safe and socially responsible manner. Improvements are continually made to strengthen the organisation's culture and commitment to health and safety.

RELIABILITY OF SUPPLY

The Group can be exposed to risks in relation to supply interruptions. A severe earthquake, storm, flood, landslide, fire, sabotage, terrorist attack, failure of critical information and control systems that support the power system, extreme weather phenomena due to climate change or any other unplanned event could lead to a prolonged and extensive power outage.

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The loss of cash flow resulting from supply interruption, and the cost of recovery from damage to network and generation assets could be considerable. Such an incident could damage customer goodwill and lead to claims and litigation. Substantial increases in the number or duration of supply interruptions could result in increases in the costs associated with the operation of the Group's supply networks, which could have an adverse effect on the business, financial condition and efficiency of operations as well as the reputation of the Group.

The Group conducts thorough risk assessment including the emerging risk of climate change, physical security and cybersecurity, adopts resilient designs, performs reliability centered maintenance and upgrades of its power supply equipment, undertakes reliability reviews, provides comprehensive training to operational staff and deploys sophisticated information technology control and asset management systems. It also conducts drills on contingency plans on a regular basis to ensure supply reliability standards are maintained.

ENVIRONMENTAL COMPLIANCE

In 2008, the Government stipulated emission allowances for the power sector up to 2010 and beyond through the Technical Memorandum for Allocation of Emission Allowances in respect of Specified Licences under the Air Pollution Control Ordinance. Five subsequent Technical Memoranda issued in 2010, 2012, 2014, 2015 and 2016 have further tightened the emission allowances starting from 2015, 2017, 2019, 2020 and 2021 respectively. The Government will also review later this year the emission allowances for 2022 and beyond based on updated information such as the availability of new gas-fired units of the power companies.

In addition, the Government currently links the rate of return to compliance with emission allowance requirements. Failure to comply with these requirements could result in financial penalties and other legal action against the Group.

The Group has in place an Environmental Management System with a monitoring and reporting mechanism run by a dedicated team to ensure compliance with relevant environmental regulations, address public concerns and closely monitor and control the emission of pollutants from the power plant.

CYBER SECURITY

The Group's critical utility and information assets are exposed to attack, damage or unauthorised access in the cyber world. The fact that cyber-attacks occur with greater frequency and intensity around the world has increased the risk posed by cybercrime to the Group. Failure to protect the Group's critical utility and information assets from targeted or

non-targeted cyber-attacks can result in reputational damage, financial loss and disruptions in operations.

The Group has taken a risk-based and integrated approach to combating cyber security risks. A robust Cyber Security Management Framework has been established with the implementation of an Information Security Management System that enables the Group to proactively identify, prevent, detect, respond to and recover from cybersecurity attacks. Resources and development efforts are focused on the three pillars of cybersecurity management, namely people, process and technology, to ensure the confidentiality, integrity and availability of corporate information assets and critical infrastructure.

LAWS AND REGULATIONS

Our main operating company, HK Electric, engages in the generation, transmission, distribution and supply of electricity in Hong Kong, and is subject to strict compliance with Hong Kong laws and regulations relating to, amongst other things, development, construction, licensing and operation of our power facilities. Furthermore, we must comply with the conditions contained in our operational and construction licenses and permits. Failure to do so could expose us to prosecution and litigation and result in fines, sanctions, criminal penalties and/or the suspension, revocation or non-renewal of licenses or permits. Moreover, changes in laws and regulations may cause us to incur additional capital expenses or other obligations or liabilities in order to comply with such changes, or possibly materially and adversely impact our business, financial condition and operating results.

The Compliance Committee is responsible for overseeing the Group's compliance functions. A Compliance Framework is in place to manage its compliance obligations under a consistent and structured approach across the Group. As part of the Framework, a Regulatory Compliance and Monitoring Programme has been implemented to proactively monitor the Group's compliance obligations and status as well as any changes in laws and regulations and their implications.

FUEL SUPPLY

Our generating units in Lamma Power Station mainly rely on coal and natural gas as a fuel source. Any interruptions or shortage in the supply of coal or natural gas or substandard fuel quality may result in significant disruption to the operations of our generating units. This could have an adverse effect on the reliability of supply, business, financial condition as well as the reputation of the Group. Possible fuel price volatility is also a risk to the Group.

The Group has a fuel supply strategy and fuel quality control system in place to maintain reliable supply and sufficient high-quality stock to meet its generation requirements.