

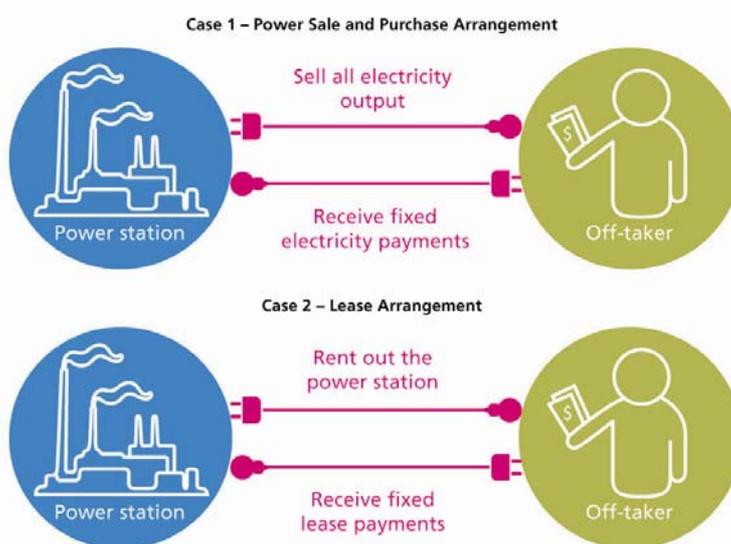
Lease accounting

What is lease accounting?

One of the complications in our financial statements is the application of “lease accounting”. We thought we should try and explain what this is, why it is used and how it affects our financial statements.

In 2006, we adopted HKFRS-Interpretation 4 “Determining whether an arrangement contains a lease”. Readers may find it hard to understand why items like “lease service income” or “finance lease receivables” appear in an electricity company’s financial statements.

The underlying logic is simple. We need to look through the legal form of a transaction and to consider its economic substance. To illustrate, consider Case 1 where a company owns and operates a power station, and under a power purchase agreement, is only allowed to sell electricity to a power purchaser (an “off-taker”) at pre-agreed sums. In Case 2, a company owns a power station but leases it out to an off-taker in return for fixed lease payments, while it remains the manager of the power station for a management fee.



The risks, returns and cash flows which a company is facing in either case are the same. To avoid manipulation and to help comparisons between the financial statements of different companies, accounting standards dictate that the same accounting treatment – lease accounting – is applied in both cases.

A number of agreements of the Group and its jointly controlled entities fall within Case 1. These involve CLP being either a power off-taker (in effect, a lessee) or a power producer (in effect, a lessor).

Being a lessee – CLP Power Hong Kong

CLP Power Hong Kong is contracted to purchase all of the output from CAPCO’s power stations for the supply of electricity in Hong Kong. Applying the lease accounting concept, this arrangement resembles a finance lease (see box below) of CAPCO’s power generating facilities. Therefore, these facilities are recorded on CLP Power Hong Kong’s balance sheet as part of the leased fixed assets with a corresponding finance lease liability. CAPCO on the other hand is viewed as the financier of the arrangement.

The payments made by CLP Power Hong Kong to CAPCO are split into three portions:

- Interest payments (expenses) on the outstanding finance lease liability;
- Repayment of the outstanding finance lease liability; and
- Payment for the use of the land on which the facilities stand and services that stem from the lease (like maintenance of the facilities), i.e. the “operating lease and lease service payments” which appear in our income statement.



Finance Lease versus Operating Lease

In a nutshell, a finance lease is one where the risks and rewards of an asset have been substantially transferred from the lessor to the lessee but not under an operating lease. The hire purchase of your home television is an example of a finance lease, while the rental of your flat on a three-year term is an example of an operating lease.

Being a lessor – GPEC and others

Our Indian subsidiary, GPEC, and other jointly controlled entities in Hong Kong, Southeast Asia and Taiwan, act as power producers and sell all their output to power purchasers at prescribed sums.

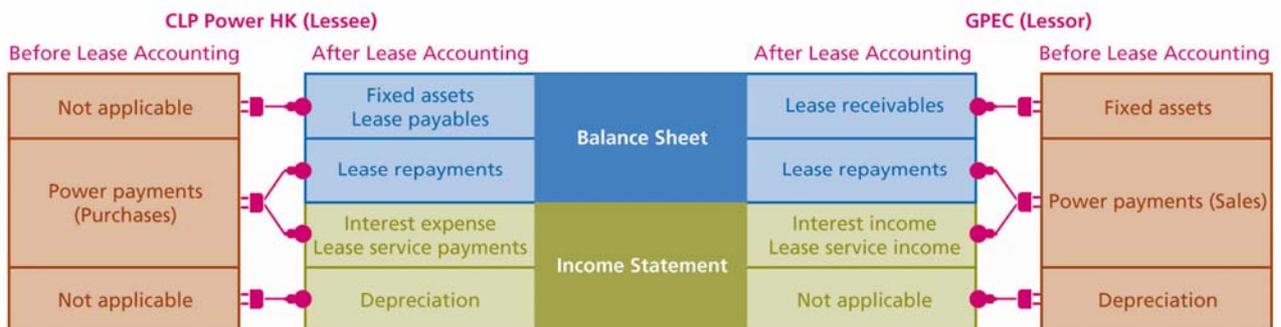
Their lease accounting mirrors the case of CLP Power Hong Kong. As a lessor (financier), finance lease receivables are recorded in place of fixed assets (the power stations) on the balance sheet. The payments received under the power purchase agreement are no longer recorded as sales, but are split into receipt of repayments for finance lease receivable, finance lease interest income and lease service income.

The balances that are visible in our financial statements are those related to GPEC, while those related to CAPCO and other jointly controlled entities are less apparent, because they are presented within “interests in jointly controlled entities” on the balance sheet and “share of results of jointly controlled entities” in the income statement.

The overall effect on CLP

Although the application of lease accounting has complicated our financial statements, it does not alter any contract terms or contracted cash flows under the power purchase agreements and therefore its real economic impacts on CLP are minimal.

On the other hand, lease accounting has the effect of levelling the profit/expense to be recognised over the term of the power purchase agreement, while the overall profit/expense is not materially altered.



Note: The definitions and explanations of the financial statements are for guidance purposes only. Readers should refer to the relevant accounting standards for comprehensive and authoritative definitions and explanations.