

## **Stage II Consultation on Future Development of the Electricity Market in Hong Kong**

### Preamble

We are pleased to note that the Government has accepted a number of our key recommendations made during the last round of consultation. These include reducing the rates of permitted return for the two power companies in the new Scheme of Control Agreements (SCAs), linking their return levels to performance in environmental protection and efficiency improvement, reviewing the permitted rate of return every five years, excluding any excessive investment of the power companies from the calculation of permitted return, and others.

On the whole, we are in support of the proposals put forward by the Government in the consultation document, which, we believe, have carefully balanced the interests of the power companies and electricity users and will enable Hong Kong to continue to enjoy high security of electricity supply. The proposed incentives are also considered effective in encouraging the utilities to reduce pollution and to enhance operational efficiency.

### Future Development of the Electricity Market

While we appreciate the great effort that the Government has put in to draw up a new regulatory framework for the future control of CLP and HEC upon the expiry of the existing SCAs in 2008, it appears to us that some of the recommendations in the consultation document are not specific enough to present a clear direction for the future development of the electricity market.

In order to remove any uncertainties, it is necessary for the Government to map out a concrete roadmap and a definite timetable for the development of the local electricity market in the longer term, particularly on how the systems between Hong Kong and the Mainland could be further integrated to facilitate supply sources from the Mainland to sell electricity in Hong Kong. With a clear market opening schedule, power companies in Hong Kong and elsewhere in China would have a better idea of how our electricity market will evolve. Such information is crucial for them to set and decide their future investment strategies.

We understand that CLP and HEC are not operating under a franchise, and any other companies may enter Hong Kong's electricity market if they meet the relevant requirements. However, given that the grid lines are owned by CLP and HEC and a low interconnectivity exists between Kowloon and Hong Kong Island, the current market structure is highly unfavourable to new power companies seeking to supply in Hong Kong. It is necessary for the Government to gradually restructure the market with a view to facilitating the importation of electricity from Mainland and allowing consumers to have a choice of suppliers. Specifically, we feel the following three targets should be completed before the expiry of the new SCAs with CLP and HEC in 2018:

- Establishing an independent regulatory authority (IRA);
- Beefing up the inter-connector between Hong Kong Island and Kowloon; and
- Allowing third party access to the grid owned by CLP and HEC (on this, there are

several models, not limited to unbundling, that the Government may consider adopting).

We believe that 12 years are sufficiently long for the Government (and later the IRA after its establishment) to prepare and complete the restructuring, and for CLP and HEC to adjust to the changes.

With regard to importing electricity from the Mainland, since maintaining a high security of electricity supply is of paramount importance to Hong Kong, a mechanism should be developed to screen any new supply sources before they are allowed to enter the local electricity market. Essentially, approval to supply in Hong Kong should only be given to those with sufficient financial strength and meeting the relevant safety, reliability and environmental standards. Moreover, the number of these approved suppliers should be strictly controlled in order to avoid any system instability and insufficient investment in new capacity that may arise from over-competition. The number of these new suppliers should ideally be no more than a handful.

#### Independent Regulatory Authority

In the consultation paper, the Government states that it will keep under review the need to set up a separate regulatory authority and prepare the groundwork for such a new setup in the future. In considering the crucial role the IRA will have to play in the market reform, we recommend that this body be set up as soon as possible after the signing of the new SCAs with the power utilities.

Once established, the IRA should assume the responsibility of regulating the technical, economic and environmental aspects of the electricity market currently undertaken by various government bureaux and departments. This arrangement would enhance the overall regulation efficiency as at present different bureaux and departments may have different priority in their regulatory work.

Aside from regulation, the future IRA should be tasked to decide on the best way to increase the transfer capacity of the inter-connector, and to prepare relevant rules and regulations and get the necessary legislations passed for enabling third party access to the grid owned by CLP and HEC.

In determining the composition and operation of the future IRA, the Government should draw on the experience of similar bodies that have been established in overseas countries. A few examples are Britain's Office of Gas and Electricity Markets, Western Australia's Economic Regulation Authority, and New Zealand's Electricity Commission.

#### Post-2008 Scheme of Control Agreements

In general, we are agreeable to the proposed framework of the new SCAs with CLP and HEC outlined in the consultation document. Below are our comments on some specific areas.

1. Permitted rates of return

We are concerned that applying different permitted rates of return to different types of assets might add complexity to the regulatory work. If the Government finds it absolutely necessary to do so, justifications should be provided for such an arrangement.

We believe that using a uniform rate of permitted return on all types of fixed assets would be a better alternative. In our previous submission, we recommended setting the permitted rate of return at 8% on average fixed assets. We maintain that this is a fair and reasonable figure, having regard to the prevailing risk levels of conducting electricity business in Hong Kong.

We agree that an incentive/penalty system should be introduced to encourage the power companies to improve efficiency, enhance reliability and reduce pollution. We propose that incentives up to a maximum of 2% be added to the permitted return if the power companies perform well against the relevant efficiency, environmental and reliability benchmarks, and a maximum of 2% penalty be deducted from the permitted return if they fail to meet the targets. In other words, the power companies may earn a maximum of 10% return and a minimum of 6% on their average fixed assets, depending on how best they perform in the promotion of efficiency and environmental protection.

## 2. Emission benchmarks

In setting the emission benchmarks, a balance should be struck between improving air quality and maintaining the reliability of electricity supply. The manner in which such benchmarks are determined should avoid overly restricting the power companies to using only one fuel, such as natural gas. It is our view that the power companies use an optimal mix of different fuels, together with the use of high quality coal and advanced emission reduction equipment, can serve the dual purposes of ensuring the security of electricity supply and protecting the environment in Hong Kong.

Besides, the pollution benchmarks to be used should be practical and pragmatic in terms of compliance, so that the power companies will not be forced to replace their existing coal-fired plants before the expiry of their normal working life with new generating units in meeting the benchmarks. We are afraid that should such a drastic change happen, it would lead to hefty increases in electricity tariffs.

## 3. Flexibility to introduce new measures

Given that the future IRA may need, from time to time, to introduce new measures to promote competition in the electricity market (e.g. enabling third party access to the network owned by CLP and HEC), a specific clause should be provided in the post-2008 SCAs to allow the introduction of such measures in the interim review. This will enable the market to evolve in a timely and flexible manner, while ensuring that the power companies will have sufficient time to cope with any change.

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