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中電集團 CLP Group

CLP's Views of Government's Consultation Paper on the Future Development of the Electricity Market in Hong Kong – Stage II Consultation

March 2006

The Government's Consultation Paper Proposals significantly increase regulatory risk, disincentivise environmental investments and reduce shareholder value to a level which is unsustainable to attract long-term investment

The excellence of our electricity supply system – supply reliability, reasonable tariffs and strong environmental performance – has not happened by chance. It demonstrates the strengths of a stable, long-term and fair regulatory regime that has steadily evolved over 40 years.

The Consultation Paper contains a number of elements with which we agree, for instance the Government's policy objectives of reliable, safe and efficient energy supplies at reasonable prices while minimising environmental impact. We note that Government recognises the value of a cost of service regime which can support the investments necessary to achieve its objectives, and that they propose this regime should continue to be regulated via a bilateral contract. This is a system which has served Hong Kong very well in the past.

However, we feel on balance that the Consultation Paper is a significant missed opportunity. Many of the proposals contain flaws which, if not corrected, will jeopardise the reliability of our electricity supply system.

In particular, we highlight the following four areas:

Environmental disincentives

- Unclear energy policy on issues such as fuel mix
- Environmental improvement investments on coal units are disincentivised with a lower rate of return, inconsistent with the objective to reduce emissions
- Emissions targets can be set unilaterally by Government without reference to practicality
- Overall return further reduced if future uncertain emissions targets are not met

Unclear plans to migrate to a competitive market

- New players being welcomed, without any clear plan of how to transition to an open market, risking disorder in the market

Duration of the regime too short

- The Government proposes to reduce the duration of the regime to 10 years, with an option to extend for 5 years
- This fails to recognise the long-term nature of the electricity industry, where asset lives are in the order of 30 years or more

Inadequate incentives to encourage appropriate investment, while risk profile will be increased substantially

- Government proposes to drastically lower the return to between 7% to 11%. We estimate this will cut shareholder value by around 30% to 50%
- The environmental disincentives, unclear plans for transition to a future competitive market, and shorter duration result in a material increase in risk, which will discourage necessary investment and compromise reliability

Hong Kong is CLP's home. We cannot ignore the deficiencies in the present proposals or agree to them as they stand. Our aim is to make sure that the new regime strikes an appropriate balance for all stakeholders and that Government's policy objectives can be met. We will work actively with Government to address our concerns, but without modifications and providing for more flexibility on these key issues, we do not believe that the proposals will be appropriate for future long term development of Hong Kong's electricity sector.

1. Why does CLP say energy and environmental policies are unclear?

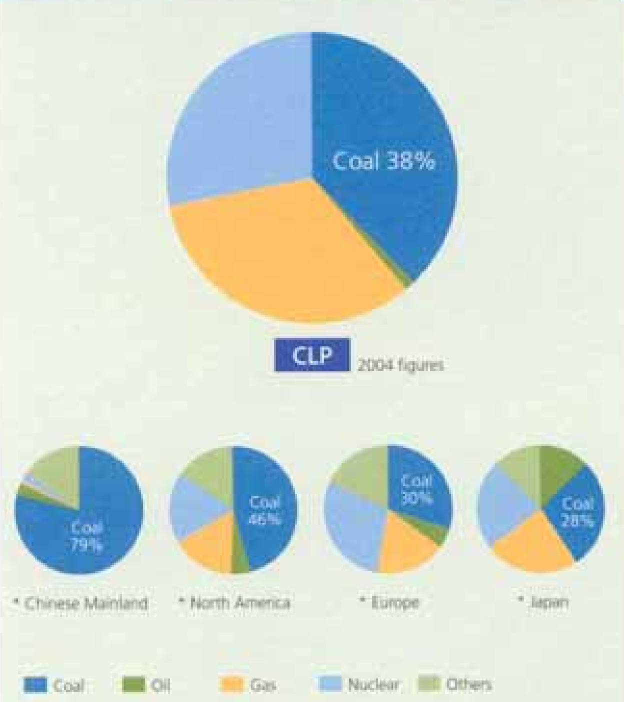
The Government's stated objectives are for the public to enjoy reliable, safe and efficient energy supplies at reasonable prices while minimising environmental impact. We support these objectives. However, to achieve them, a clear and long-term energy policy is needed. For example:

Does Government want Hong Kong's existing coal units to be maintained for the next 10-15 years?

Does Government want more gas generation over the next decade? If yes, how can we as a society facilitate the import of more gas resources?

The Government should provide a clear policy direction on Hong Kong's long term fuel mix, and then set consistent standards for emissions that recognise the role of each of the fuel elements and practical technical capabilities. Such standards cannot be set arbitrarily without reference to the energy policy.

Coal Remains a Key Element for Reliable Power Supply



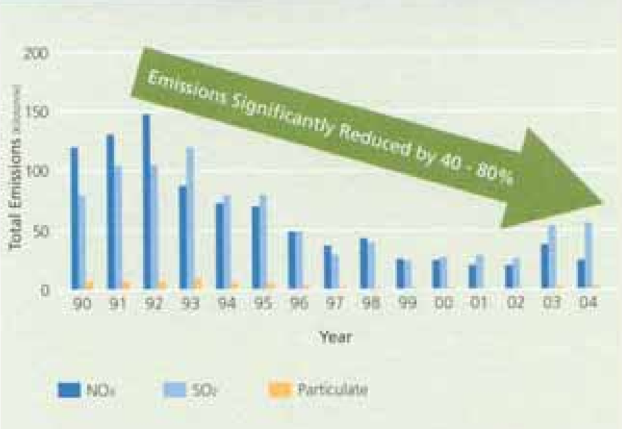
* Percentage quoted for fuel combination are 2003 figures
Source: International Energy Agency

2. What is the impact to CLP's operation of the proposed environmental penalty?

We do not know how emissions standards or penalties will be set in the future. But our experience over the last few years suggests they could be set without due regard for the necessity, for supply reliability reasons, of coal generation as part of the fuel mix. If CLP were forced to replace all our existing coal units with gas units, this would increase tariffs by around 30%. In addition, relying solely on gas puts us at a higher risk of security of supply.

Unless such issues are fully assessed, there is a real danger that a perfectly sincere environmental agenda will lead to unanticipated problems affecting society.

CLP's Emissions Reduced Significantly Between 1990 and 2004



Despite an increase of about 70% in local electricity sales since 1990, CLP's total emissions in Hong Kong in 2004 were much lower than our 1990 level

3. Why can CLP not accept the proposed lower return for emissions control equipment?

We think this proposal is illogical and counter-productive. If emissions control investment delivers the environmental policy objective of lowering emissions, then why discourage that by offering a lower rate of return? CLP should be encouraged to install the most advanced emissions reduction equipment if the energy policy recognises that coal is an essential fuel element. The proposed return is inadequate.

4. Why complain about having no clear plan to migrate to a competitive market?

Competitive markets have been introduced in some parts of the world. The CLP Group itself has invested significantly in Australia, a fiercely competitive market. We understand the conditions that are required for these markets to function – they do not yet exist in Hong Kong. A meaningful electricity market in Hong Kong can only be realised on an integrated basis with South China, on a level playing-field basis, and when conditions in South China allow. Government's unclear policy in introducing new players could result in neither a regulated nor a competitive market. We are expected to make major investments and commitments on gas purchases without clarity as to how many customers we need to serve.

A disorderly market opening benefits the few at the expense of the many. New entrants will cherry pick large customers and the remaining smaller customers will have to pay higher tariffs as a result.

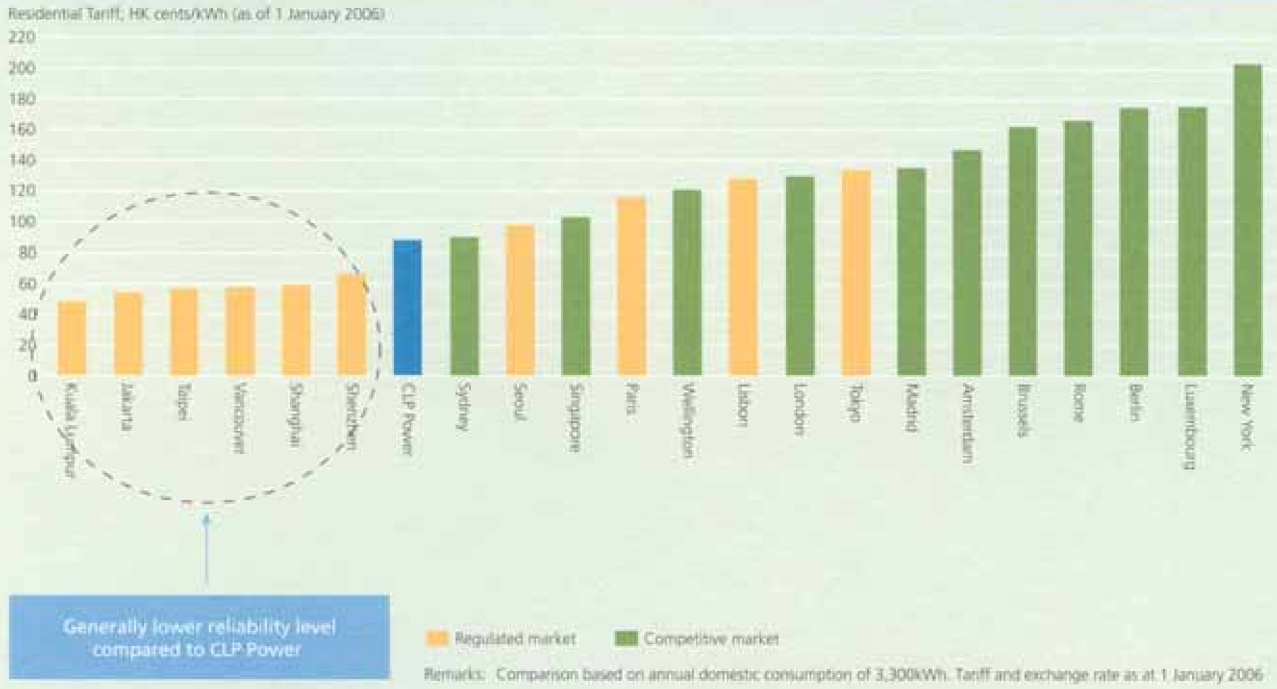
5. Is the tariff too high? Should Government consider affordability when approving the tariff?

CLP's electricity tariffs are highly competitive and good value-for-money. We deliver world-class reliability at moderate prices. Over the past 8 years, tariffs have been frozen despite yearly investment by CLP of around HK$6 billion. We also rebated HK$3 billion to our customers.

Our tariffs are significantly lower than comparable metropolitan cities such as New York, London and Tokyo. They are also affordable to our customers. Electricity accounts for only 1.3% to 2.7% of monthly household expenditure in Hong Kong.

It is very important that the tariff setting mechanism is clear and objective to allow the industry to develop on a sustainable basis. The collapse of California's electricity market earlier this decade was in large part due to political meddling in setting electricity tariffs.

Tariff Comparison Worldwide



Remarks: Comparison based on annual domestic consumption of 3,300kWh. Tariff and exchange rate as at 1 January 2006

Our Views – Question and Answer Session

6. Why does CLP say that incentives for investment are inadequate?

The proposals call for a 30% to 50% reduction in return, and the duration of the agreement to be reduced from 15 years to 10 years. These changes dramatically decrease investment incentives and jeopardize future investment in the electricity sector, risking reliability of our electricity supply system.

7. Why do Government's proposals significantly increase risk?

There are two main reasons for the increase in risk:

- Unreasonable environmental regulations. If emissions targets are set unilaterally with little regard to practicality then our return, if it is linked to the targets, is exposed to significant risk. The future of investments, for example coal fired plant, is also placed in doubt.
- An unclear plan to migrate to a competitive market significantly increases CLP's exposure to stranded investments and huge fuel supply commitments beyond the end of the next regime.

8. Why is the proposed return unacceptable?

Power industry investments are typically large, long-term and immobile, so the risks involved in these investments are very high. Investment risk can only be assumed and decisions can only be made based on a reasonable and clear return.

An appropriate return level should be commensurate with the risks assumed by investors in the power industry. The Government in its proposals has introduced further uncertainties, and thus more risk. We must work with Government to clarify these uncertainties before we discuss the return level that is commensurate with the risks.

9. What is wrong with a 10-year duration for the next regime?

The cost and magnitude of power industry assets are very significant, with asset lives in the order of 30 years or more; additionally, gas suppliers typically demand 20 year fuel purchase commitments. Project lead time can easily take 7 to 8 years. The 15 year regime duration adopted in the past was a sensible compromise based on the assumption that the SoC regime would not be abruptly abandoned at the end of its term.

We now face a new situation, including possible transition to an open market. The regime duration needs to be lengthened to address these additional regime risks faced by investors.

10. How does CLP propose to take things forward?

The current regulatory regime has delivered significant value to Hong Kong – a reliable electricity system, value-for-money tariffs, a framework which has required no taxpayer subsidy, and a clear line of accountability and responsibility for electricity supply.

We understand there are areas of our regime that may warrant modification to reflect changes and challenges arising from the economic and social development of Hong Kong. CLP will continue to work with the Government to find the best way to serve Hong Kong. At the same time, we will continue to share our views and thoughts with the public.

We hope this leaflet has facilitated your understanding of the subject and, more importantly, you will consider submitting your views to the Government. This can be done by writing to the Economic Development and Labour Bureau at 2/F, Central Government Offices, Main & East Wings, Lower Albert Road, Central (fax : 852 2868-4679) or by e-mail to **electricitycommentstage2@edlb.gov.hk**. The consultation period closes on the 31 March 2006.

Should you decide to write a response to the consultation we would advise you to make your comments as specific as possible, citing the particular areas where you agree or disagree. This will result in the most accurate reflection of your views when Government decides how to proceed with electricity sector regulation.