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Legislative Council Panel on Economic Development

Annual Tariff Review with the Power Companies
Supplementary Information

PURPOSE

This Paper aims to provide the Administration's views on the information submitted by the CLP Power Hong Kong Limited (CLP) to the Panel regarding its 2012 Tariff Review.

VIEWS OF THE ENVIRONMENT BUREAU

2. CLP has submitted to the Panel two documents (one at the Annex, and the other confidential document exclusively for Members' reference). To facilitate Members' understanding of the issues at stake, the Administration provides its views on the major content of the Annex (with relevant parts marked), as follows -

(a) In replying the Hon Fred Li's oral question two days ago, the Secretary for the Environment (SEN) already pointed out the Administration's queries on CLP's operating costs. The Administration has the following views regarding the documents -

- regarding part "A" of the Annex, as the Administration has been pointing out, the increase in operating costs in 2012 due to emission control only accounts for a very small sum of CLP's overall increase in operating costs. Members may refer to paragraph 2.1 in CLP's confidential document;

- regarding part "B" of the Annex, as mentioned by SEN in response to the Hon Fred Li's oral question, CLP's operating costs in 2011 are not particularly low as claimed. In fact, they are higher than those in all previous years.

(b) Regarding CLP’s capital investment, those “premature investment items” which we have questioned are primarily the “Preparatory work and Stage 1” for Additional Generation Capacity projects (see Notes # in the bottom of page 4 of CLP’s confidential document). It is estimated that these items will require capital expenditure in hundreds of millions in 2012 (Members may request CLP to provide the exact figure). They are neither purely feasibility study as claimed by CLP, nor involving only $78 million as indicated by CLP in the Annex (see Part “C”). These projects have yet to be fully vetted or included in the current Development Plan. Since the maximum demand for CLP’s power generation in 2011 was lower than that in 2010, hence lacking justifications for increasing its generation capacity, we have requested CLP to take out the relevant items from its forecast capital expenditure in 2012. Although the expenditure involved does not have a significant impact on the 2012 Basic Tariff, the Administration is concerned that, as the projects involve additional generation capacity and may entail huge capital expenditure if continuous investment is required, they would lead to an even bigger increase in Basic Tariff in future.

However, these capital investments require the Government’s approval before they could be included in CLP’s Fixed Assets and earn Permitted Return. Hence, even if CLP eventually refused to take out the relevant expenses from the forecast for the 2012 Tariff Review, so long as these items are not approved by the Government, CLP could not make any capital investment in these “Preparatory work and Stage 1” projects. In such circumstances, CLP’s actual Permitted Return would be lower than the original forecast, and the difference would be transferred to the Tariff Stabilisation Fund (TSF).

(c) CLP has also indicated in part "D" of the Annex that out of the 85 cents of the new Basic Tariff, more than 4 cents are needed to meet the costs associated with the emission control facilities commissioned in early 2011. However, we must stress that CLP already completed the emission control project by phases in 2010 and 2011. The impact of 4 cents arising from the emissions control project has already been reflected in the Basic Tariff for 2011. Hence, the emission control project is not the major cause for the increase in Basic Tariff for 2012.

(d) Regarding TSF, CLP projects a balance of $300 million by end 2012 and claims that this amount would be the lowest in the past 25 years. As mentioned in our reply to the Hon Fred Li's oral question -

(i) Firstly, CLP projected in 2008 an end 2009 TSF balance of $150 million. Hence, the current forecast of $300 million by end 2012 is not the lowest figure in the last 25 years as claimed by CLP. It is not reasonable to compare the forecast balance with the actual balance;

(ii) CLP underestimated its TSF balance in eight out of the past ten years. For example, for 2009, the forecast balance was $150 million, yet the actual outturn was $1.65 billion, which was 11 times of the original forecast. Hence the Administration is particularly cautious on CLP's forecast of TSF balance;

(iii) Of the two power companies, CLP has been maintaining a higher balance of TSF. For years 2001 to 2008 under the previous Scheme of Control Agreement (SCA), the average balance of CLP's TSF was close to $3 billion. The new SCA introduced new control measures to lower the cap on TSF balance from 12.5% to 8% of annual local sales. CLP's TSF balance has been reduced gradually from $1.65 billion since 2009, but is still higher than that of

Hongkong Electric Company Limited (HEC). For comparison, the balance of HEC's TSF was zero in four out of the past ten years, while the highest balances were only around $300 million to $500 million in remaining years; and

(iv) Another factor which may affect the TSF balance is revenue from the sale of electricity to Guangdong. In adjusting next year's Basic Tariff, CLP assumes that unlike previous years, it would not sell electricity to Guangdong Power Grid Corporation (GPG) in 2012. Since CLP should return to its consumers 80% of the net profits in the relevant electricity sale, it is very likely that the balance of CLP's TSF would increase if CLP is going to sell electricity to GPG next year. CLP's net profit from the sale of electricity to Guangdong in 2010 was $365 million, in which close to $300 million was returned to its consumers; if Permitted Return is exceeded, the excess will be transferred to the TSF.

The TSF is established primarily for mitigating the impact of tariff surge on the general public when there is a huge tariff increase pressure. However, in the years when the power companies are unable to earn up to the Permitted Return, the TSF can cover up the shortfall. It is now the time for the TSF to play its role when Hong Kong is currently suffering from an uncertain global economic outlook and a local inflation pressure.

3. In view of the above, we consider that there is still room for CLP to reduce the tariff increase.

BACKGROUND

4. Pursuant to paragraph B(1)(b) of Schedule 3 to the current SCA, the two power companies will make available to the Government for the purpose of the Tariff Review their respective financial and operational information and forecasts on specific items in respect of the relevant years. Owing to the need to protect the sensitive nature of

certain information, the Administration will strictly observe the confidentiality rule, and may disclose such information to any third party only with the prior written consent of the power companies.

5. At the meeting of Legislative Council Panel on Economic Development on 13 December 2011, Members requested CLP and HEC to provide more detailed financial information relating to the 2012 Tariff Review.

Environment Bureau
December 2011

CLP Power 2012 Tariff Review – Clarifications

In view of the recent discussions and the legislators' call for information to understand more about the reasons for CLP's tariff increase for 2012, supplementary information is provided to facilitate a more informed discussion on the issue.

CLP's Tariff Pressure

CLP has been diligent and prudent in controlling our costs. Even after the increase proposed for 2012, the Basic Tariff level is still below the level approved by the Government and the Executive Council for 2012 as listed in the 2008 Development Plan. The new tariff also remains below our Basic Tariff level of 1997.

Out of the 85 cents of the new Basic Tariff, more than 4 cents represent costs associated with the Emissions Control facilities that have been completed in early 2011 in order to meet the Government's emissions caps, which we have a legal obligation. Such costs include the relevant operating expenses, materials (eg. limestone, urea) and depreciation costs of the project.

D

In addition, we have also begun to construct facilities needed to receive new gas before the second half of 2012, and continue to make necessary investment to meet customers demand and support major Government infrastructure projects. All these contribute to the unprecedented pressure on our Basic Tariff and thus tariff adjustment is required.

CLP's Operating Costs

Concerns have been voiced over the 11.2% increase in operating costs in 2012 which may appear to be a high number compared with 2011. This is because of two major factors:

B

A

- There are a number of additional incremental costs that we have to incur in 2012, such as those required to run the newly commissioned Emissions Control facilities, in order to meet the Government's emissions caps
- The operating costs of 2011 form an artificially low base year (only 1.4% up on 2010 costs), which is a result of exceptional items, such as the $50m received from insurers in respect of claims as well as below trend net fixed asset disposals.

Adjusting for these factors, the increase in our operating costs for 2012 will be around 6%, close to the general rate of inflation. These operating costs in total are around $3.9 billion, representing only some 15% of our total expenditure. They are core operating costs covering labour, materials, Government rent and rates, pumped storage, etc, which are essential for the company's daily operation.

CLP's Capital Expenditure for the proposed increase in Generation Capacity

In accordance with the approved 2008 Development Plan, CLP has been undertaking feasibility studies to explore options for a necessary increase in generating capacity for meeting electricity demand by the middle of this decade.

C

Regular discussions with the government on the issue have been underway for at least 18 months. As such, feasibility studies, with a total cost of $78m, have already progressed in 2011. Additional study and preparatory work have to be continued in

2012, so as to ensure our supply reliability in view of the expected increase in demand.

In line with accepted practice under the Scheme of Control for many years, we treated these preliminary costs as capital investment, as opposed to immediate expenses, so that they can be recovered over the expected 25-year life of the new plant. This has already helped spread out the cost impact, which results in lesser impact on the current tariff than if the costs were treated as immediate expenses.

Using Tariff Stabilization Fund (TSF) to reduce tariff increase

There is a general query about CLP's willingness to make use of the TSF balance to help reduce the tariff increase. As a matter of fact, CLP has already drawn down an amount of some $1,200m from the $1,900m TSF balance at the start of the 2008 Development Plan, to less than $700m this year. Even after the proposed increase in the Basic Tariff announced on 13 December, it is projected that the TSF balance will be further lowered to $300m by the end of 2012, which is less than one-sixth of the amount it was in 2008. This is also the lowest level in more than 25 years, equal to only a few days of sales revenue. This exceptionally low level of the TSF account means that it can no longer serve the purpose of stabilizing tariff fluctuation.

Fuel Costs

Our customers are currently paying very low prices for natural gas, which was secured by CLP some 20 years ago. The current market prices are much higher, some two to three times more expensive than we have enjoyed. Furthermore, the need to comply with the Government's newly imposed 2015 emissions caps, means that we have to use more than double the amount of natural gas in our fuel mix by then. A doubling of volumes and close to a tripling on unit prices for natural gas translates into a six-fold increase in our fuel costs when fully implemented.

CLP's Fuel Clause Account (FCA) has been in deficit for five consecutive years, with a further deficit forecast of over $800m* by the end of 2012. The FCA deficit is a liability of our customers and will only increase pressures on tariff in future. As a responsible company, we must give very prudent consideration on any decision for further deepening such a deficit.

* With the further reduction of the Fuel Clause Charge increase for 2012 announced on 21 December, deficit forecast of the FCA will further rise to $1,400m by the end of 2012.

Rent & Rates

Regarding the discussions on the refund of the Government's Rents and Rates, CLP has an ongoing legal case which is still being contested by Government through a judicial process.

If there is any refund of money from the Government from this case, it will be used up to help cut the overall operating expenses, therefore reducing pressure for tariff adjustment.