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LEGISLATIVE COUNCIL PANEL ON ECONOMIC SERVICES

SCHEME OF CONTROL AGREEMENTS WITH THE POWER COMPANIES

2003 INTERIM REVIEW

INTRODUCTION

This paper informs Members of the results of the 2003 Interim Review of the Scheme of Control Agreements (SCAs) with the two power companies.

BACKGROUND AND ARGUMENT

General Background

2. The Government has entered into two SCAs - one with CLP Power Hong Kong Limited, its electricity generation partner ExxonMobil Energy Limited, and a related company (CLP/ExxonMobil); and the other with The Hongkong Electric Company Limited, and its holding company Hongkong Electric Holdings Limited (HEC/Holdings).

3. Under the SCAs, the power companies have the obligation to provide sufficient facilities to meet the present and future demand for electricity and to provide a service to the public that is reliable, adequate, efficient, of high quality and at reasonable price. The financial affairs of their electricity-related activities are subject to monitoring by Government through periodic financial reviews, annual tariff and auditing reviews to be conducted jointly by Government and the power companies.

4. The SCAs run for 15 years. The current SCAs, with provision for two interim reviews of one-year duration each in 1997/98 and 2003, will expire in 2008 (30 September for CLP and 31 December for HEC). During the interim reviews, the parties to the agreement have the right to request modifications to the SCA. Modifications, however, can only be put into effect, if they are agreed to by both sides.

Public Concern With the SCAs

5. There have been criticisms of the SCAs from time to time. The main concerns are that -

(a) linking the return for shareholders to the value of the fixed assets encourages over-investment by the power companies;

(b) the levels of return for shareholders are too high in today's circumstances and should be lowered; and

(c) tariff should be linked to and adjusted in accordance with changes in local consumer price index.

THE 2003 INTERIM REVIEW

6. Pursuant to Clause 7(2) and Clause 11(2) of the SCAs with the CLP and the HEC respectively, we initiated discussions with the two power companies on the Interim Review at the beginning of this year. In the process of the Review, the Government has taken on board and pursued with the power companies the issues raised over time by the community and Members of the Legislative Council. The Review covered issues ranging from those of direct concern to the public to those concerning procedures and arrangements for administering the SCAs by the Government.

I. Outcome and Assessment

A. Agreement Reached

Financial and Administrative Issues

7. After protracted discussions, agreement has been reached with the power companies on the following -

With CLP

(a) Changes in depreciation periods for fixed assets

The depreciation period for certain fixed assets will be extended. The 'useful' life of most of the CLP's plant and facilities, other than the generators, will henceforth be the same as those of HEC;

and land on lease terms will also be depreciated in accordance with standard accounting practice. According to CLP, changing the depreciation periods would lead to savings of about $650 million (or 0.3 to 0.6 cents per kWh) for the consumers between 2004 and 2008.

With HEC

(b) Excess capacity penalty

HEC agreed that, for projects approved as from 2004, the deduction from average net fixed assets (ANFA) for excess capacity will be increased from 40% to 50% of the mechanical and electrical equipment costs.

ANFA is the basis on which Permitted Return is calculated. The arrangement represents an alternative approach to containing the Permitted Return available to the Company.

With CLP and HEC

(c) A mechanism to contain the Development Fund (DF) balance at a reasonable level

There will be a cap, equivalent to 12.5% of the Company's annual local sales, on the balance in the DF. Excess above this level will be returned to consumers in the immediate following year in the form of one-off rebate or tariff reduction.

This trigger mechanism should go some way towards addressing the long time concern that CLP has been accumulating a large 'reserve' and keeping to the Company monies that belong to the consumers. And, the implicit 'automaticity' of this mechanism should eliminate, to a certain extent, the perennial agony of having to negotiate with CLP to 'release' funds in the DF account. Over the past four years covered by the current Financial Plan, CLP's DF Balance had been in excess of 13% of local sales on an annual basis : setting the cap at 12.5% would hence be reasonable. This, of course, will not stop us from seeking 'releases', even if the cap is not reached or 'releases' which will bring the balance to levels below the cap.

(d) A mechanism to deal with balances in the DF and Rate Reduction Reserve (RRR) upon the expiry of SCA

There will be an 'additional' provision to the effect that the Government and the Company concerned will have specific discussions with regard to arrangements to deal with any balance in the DF, and the related RRR account, twelve months before the expiry of the current SCA.

The SCA, as is, states that the DF shall not accrue to the benefit of shareholder, but is silent on how any balance should be dealt with upon the expiry of the SCA. In view of the expiry of the SCA in 2008 and our review on the electricity supply market post-2008, it would be prudent to have in place a mechanism whereby any balance in the DF, and the RRR account, will be returned to the consumers. Nevertheless, since we are uncertain, at this early stage, as to the balance or the 'beneficiary' in these accounts, we opine it suffice to have in place a mechanism which might be triggered as necessary.

This 'additional' provision should again go some way towards addressing concern that consumers' money might be taken up by the power companies when the SCAs expire.

(e) Three-year Rolling Forecasts

To facilitate our monitoring of the DF, the Fuel Clause Account and RRR over a longer timeframe, the two power companies will provide three-year Rolling Forecasts to the Government at the time of the Annual Tariff Review.

(f) Enhancing transparency

The two power companies will segregate and present cost data pertaining to generation, and transmission and distribution (T&D) systems in the Financial Review and Auditing Review for the Government's consumption.

Having the data segregated for generation and T&D is a major step to assist us in the post-2008 review to consider options for the generation and T&D of the two power companies.

Environmental Issues

8. On the environmental agenda, we have reached the following understanding with the power companies -

(a) Recognising Government's effort to improve regional air quality

The power companies recognize the Government's efforts to improve regional air quality. The Government will continue discussions with the power companies on substantive means to achieving emission reduction.

(b) Exploring alternative power generation sources

The power companies recognize the Government's efforts in exploring alternative power sources including renewable energy, to supplement conventional power generation from fossil fuels and in promoting public awareness of these alternative power sources and participation in the exploration. To this end, the companies are prepared to plan and set up commercial scale wind turbines for public demonstration and efficiency testing, subject to detailed feasibility studies and further discussion on the implementation details with the Government.

(c) Environmental Performance Report

The power companies will keep the public informed of their environmental performance on a regular basis.

B. Points of Dissent

9. Both Companies opine that the SCA is a 15-year contract, both their management and their shareholders do not expect, and will not accept any major changes to the SCAs which will expire in five years' time. They did not therefore accept our proposal to -

(i) reduce their permitted return, with the view to lowering tariff; or

(ii) link the annual tariff adjustments to changes in the local CPI, to reflect the prevailing economic situation.

The stances of the parties on the various issues are detailed in paragraphs

10 to 17 below.

For CLP and HEC

(a) Permitted Return

10. Under the existing arrangement, the net return for shareholders of the power companies shall be calculated by first determining the permitted return which shall be -

(a) 13.5% of the total value of the ANFA; plus

(b) an additional 1.5% for those fixed assets acquired with shareholders' funds after 30 September 1978 and 31 December 1978 for CLP/ExxonMobil and HEC respectively.

For fixed assets financed by two types of non-shareholders' funds, namely borrowings or the DF, interest on the borrowed capital of up to 8% per annum or interest at 8% on the average balance of the DF shall be deducted from the permitted return to arrive at the net return.

11. During the interim review, we had proposed to -

(a) abolish the additional 1.5% permitted return, since the additional risks perceived by investors in 1978 over the change in sovereignty no longer exist; and

(b) reduce by 8% the permitted return on fixed assets acquired with borrowed capital and with funds provided directly or indirectly by consumers, as in the case of assets acquired with funds from the DF.

12. Both power companies rejected our proposals. They were of the view that the SCAs were 15-year contracts, that permitted return was critical and crucial to the SCAs, and that the existing rates were sacrosanct : their shareholders would not accept such major changes to the SCAs, due to expire in five years.

(b) Tariff and Consumer Price Index (CPI)

13. We had proposed to link the annual tariff adjustment to the local CPI to reflect the prevailing economic situation. The two power

companies did not accept our proposal : they considered introduction of tariff cap or a CPI-related formula a major change in the regulation mechanism, hence tantamount to scrapping the SCAs and inappropriate in the context of the Interim Review exercise. Moreover, they were of the view that the existing tariff adjustment mechanism and process had already provided a good forum for the power companies to take into consideration the prevailing economic situation and Government's views.

(c) Scope of ANFA

14. Both companies did not agree to our proposal to restrict new facilities acquired from 2004 onwards, which would be counted towards ANFA, to those essential to the supply of electricity, i.e. generation plants and T&D facilities, instead of 'electricity-related'[(Note 1)] facilities as defined in the SCA, noting that it would be a substantial departure from the original package.

For CLP

(d) Excess Capacity

15. In the 1997/98 interim review, both power companies agreed to put in place a mechanism for determining the excess generation capacity, and for 40% of the mechanical and electrical equipment costs of new generation projects that gave rise to the excess capacity to be excluded from attracting a return for the power companies.

16. We had proposed to refine this mechanism with a view to shifting more investment risk to shareholders. CLP did not agree to changes to the established arrangement. HEC was more amenable, vide paragraph 7(b) above.

17. We had also proposed to apply the mechanism for excess capacity to CLP's generation units C7 and C8 after their commissioning in 2005/2006. CLP did not accept our proposal, noting that the test should not be applied to generation units which were contractually committed before the mechanism was introduced.

[(Note 1)] According to the SCAs, 'electricity-related' means directly or indirectly appertaining to the generation, transmission, distribution and sale of electricity and energy efficiency and conservation.

II. Conclusion

18. The agreement secured would bring about material benefit to the consumers (e.g. extended depreciation period, DF cap in the case of CLP); and prepare the ground for follow up action upon the expiry of the current SCAs (segregation of data for generation and T&D, and arrangement for disposal of the DF upon the expiry of the current SCAs.)

19. The public would wish to see more improvements to the existing arrangement and more concessions by the power companies. However, modifications to SCAs can only be made with the agreement of both parties and cannot be unilaterally imposed by the Government.

20. More importantly, the blackout scenes in various parts of the world, including London, the northeast states of the USA, Canada, various countries in Europe and Asia, in August and September this year, served as a timely reminder to the vital importance of reliable and safe power supply. Stable and adequate power supply hinges on adequate investment in power systems. And the SCAs have proved to have provided the basis for the companies to make appropriate investment in power supply. The reliability of power supplied by both companies is over 99.99%, which is among the highest in the world. And, the two power companies will be expected to be as, if not more, vigilant in ensuring that they continue to live up to their obligations under the SCAs, as they have been vigilant in safeguarding their entitlements under the SCAs.

III. Implementation

21. We shall work out the legal instruments with the respective power company to give effect to the revised arrangements, which will be implemented as from 1 January 2004.

Consultation with the Energy Advisory Committee

22. We consulted the Energy Advisory Committee on 19 November 2003 on the result of the interim review. The Committee noted that the improvements made to the SCAs were the best we could achieve in the circumstances.

MEMBERS' ADVICE

23. Members are invited to note the results of the 2003 Interim Review.

Economic Development Branch
Economic Development and Labour Bureau
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