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Consumer Council
Submission to LegCo Panel on Economic Services
Arrangements to cater for new supply sources for the future electricity market
in Hong Kong

Introduction

1. The Council welcomes this opportunity to present its views to the Panel on Economic Services with regard to the arrangements to cater for new supply sources for the future electricity market in Hong Kong, and related issues such as grid access and increased interconnection, relevant regulatory framework, and the timeframe in further opening up the electricity market.

Competition as the driving force in economic efficiency

2. Certain stakeholders hold the view that disturbing the status quo could be disruptive to reliability. In addition, there are claims that any perceived economic benefits from introducing competition into the sector may be less than expected.
3. The Council considers that the primary issue in the debate on the future direction for the sector should be how Hong Kong can strive for increasingly efficient service provision. Whilst efficiency gains might be derived from hands on regulation by administrative means, it is logical for a highly successful open market economy such as Hong Kong, to apply competitive processes wherever it is possible, in the delivery of these services, as a means of enhancing efficiency.
4. The Council acknowledges that because of the nature and the circumstances of the electricity sector in HK, any market liberalization will only result in limited competition; at least in the early stages of liberalization. This is because of the impracticalities or difficulty in duplicating infrastructure, and the historical monopoly endowments that incumbents will bring with them to the bargaining table - whether it be bargaining with Government or bargaining with potential competitors at the various functional levels in the electricity sector who will want access to existing infrastructure. Moreover, having regard to the experience of liberalisation in other comparable economies, the benefits that will accrue from liberalisation in the early stages will most likely only affect commercial, as distinct from residential consumers.

Incremental approach to liberalisation

5. The Council therefore considers that an incremental approach should be taken in finding an appropriate balance that delivers an efficient and low cost service to consumers through a mix of regulatory initiatives and open competition. Accordingly, the Council considers that administrative oversight by Government, in addition to incremental initiatives to introduce competition and open up the market, wherever feasible, is the best solution.

Regulatory oversight

6. The Council considers that a designated agency should be created to oversee the introduction of competition into the power sector. There are lessons that can be learned from the mistakes made and the benefits achieved, from similar market liberalisation in other comparable advanced economies. As shown in other economies, market liberalisation requires

ongoing scrutiny by a government agency that has in place rules that can be used to adapt quickly to any issues that may arise, in particular:

- a) monitoring infrastructure development to maintain existing standards of reliability through appropriate investment levels;
 - b) providing competitive safeguards, for example, legislative right of access for new entrants to existing infrastructure on reasonable terms to be agreed with the incumbent owners; and
 - c) maintaining retail prices oversight, to ensure that all consumers benefit from the efficiency gains in market liberalisation.
7. This form of oversight is similar to that successfully exercised in Hong Kong by the Office of the Telecommunications Authority (OFTA) in the liberalisation of the telecommunications sector.
 8. As a preliminary step, the Council agrees with maintaining the scheme of control (SOC) type arrangements, and the proposed safeguards in the new SOC for Government to approve all development plans and tariff adjustments, renewable energy requirements, and a review of the permitted rate of return every five years, to ascertain the need for adjustment.
 9. A critical issue in maintaining regulatory oversight is the need for adequate information on which to base decisions. The Government has stated that it will request power companies to make available more information to the public, such as details of new development projects, electricity sales and growth rates, provided that no commercially sensitive information would be disclosed. This increase in transparency is welcomed, not only for the public who pay for the service and need to be assured their interests are being protected, but also for potential entrants who will need some information upon which to base investment decisions. Accordingly, the Government must not be persuaded by exaggerated 'commercial in confidence' arguments likely to be advanced by the power companies in order to protect data held by them. This is because the market is not liberalized, and the process of liberalization will therefore require the disclosure of more information from the monopoly suppliers.

Increased interconnection

10. As part of the incremental approach towards liberalisation, the Council considers that the SOC should be drafted in a manner to place obligations on the current incumbents to implement an interconnected power system, with the ultimate purpose of setting an environment conducive to allowing other competing generators to supply power into the grid.
11. At the outset, this could be achieved through bilateral and multilateral agreements between generators and the owners of infrastructure, encouraged through obligations in the SOC. Eventually, these agreements, together with any pooling schemes (similar to those that exist in other jurisdictions) would need to be governed by rules administered by the designated agency under a licensing scheme.
12. It appears that there are two means by which competing generation could be introduced. The first is to have in place legal obligations by the incumbents (at the moment through the SOC) to increase interconnection between

themselves; to make the grid available to any local generators, for example any small scale environmentally sustainable generation, and through access to the Mainland.

13. The Council understands that with regard to the Mainland, there are some options that could be safely pursued now without jeopardising reliability. The Council understands that there are three types of supply from the Mainland:

- a) firm supply from a dedicated plant linked by a feeder line to Hong Kong, and not strongly linked to the Mainland system;
- b) allegedly firm supply by a plant that is integral with the Mainland system, and supplies might be cut to support the Mainland; and
- c) economic interchange to take short term advantage of diversity of demand and lower demand periods when the marginal costs of the systems might differ.

14. It would appear that only the second type of supply would pose any threat to reliability of supply in Hong Kong and that at least two options could therefore be safely pursued. In order to reduce uncertainties in the electricity sector, thus affecting the investment incentives of the incumbent power companies and any potential entrants into Hong Kong, the Council has suggested that the Government should ideally start the assessment immediately.

Retail prices oversight

15. Experience in other comparable economies, that have liberalised the sector, has shown that continuing oversight of retail prices is essential. This is due to the fact that introducing competing generators at the early stages is not likely to bring immediate benefits to residential consumers. In particular, it has been shown that where new entry occurs, the problem of 'cherry picking' might arise. 'Cherry picking' refers to the practice whereby one or more suppliers capture low transaction cost customers (i.e. large commercial entities) that are therefore more profitable customers, and another supplier is left to service the high transaction cost customers (i.e. residential consumers).

16. The extent to which this constitutes a real concern depends on the extent to which the Hong Kong market is liberalized, and the extent to which competing suppliers are able to capture certain customers at a price that puts other suppliers at a disadvantage because of universal service obligations.

17. The Council expects that the Government will consider measures to ensure that residential consumers are not disadvantaged by having to pay higher tariffs as a consequence of efficiency gains made for commercial customers due to the introduction of competing suppliers (returns for incumbents are protected under the SOC whilst observing the universal service obligations). For example, two possible measures could be price freezes for residential consumers at the onset of competition; and competing suppliers being required to fund universal service obligations for residential consumers, through the payment of an industry levy.