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14 May 2008

BY EMAIL (audrey_eu@hotmail.com)

Hon Audrey Eu Yuet-mee SC, JP
Room 601, Citibank Tower
3 Garden Road, Central
Hong Kong

3308 GLOUCESTER TOWER
THE LANDMARK
CENTRAL, HONG KONG

TEL +852 3601.9000
FAX +852 3601.9100
www.bakerbotts.com

David Renton
TEL +852 3601 9280
FAX +852 2522 6920
david.renton@bakerbotts.com

AUSTIN
BEIJING
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Dear Ms Eu:

I am writing to you as a lawyer living in Hong Kong to express my personal concern about the Air Pollution Control (Amendment) Bill 2008, which is currently under consideration by the Bill Committee you chair. The Bill would give the Administration wide discretion to approve emission trading schemes for power plants in the Pearl River Delta Region without providing legal safeguards to ensure that the trading of emission allowances will not cause Hong Kong's air quality to deteriorate further.

The Government's stated objective in introducing the Bill is to introduce a clear and transparent framework for regulating the emission of three specified air pollutants¹ by power plants, but the Administration has been vague about how the trading scheme will work. In particular, it is unclear what effect the new market-oriented arrangements will have on the existing arrangements for controlling air pollution under the Air Pollution Control Ordinance (APCO).

The APCO gives the Government broad powers to regulate pollutants emitted into the atmosphere. Licences issued to the two Hong Kong power companies under section 15 of the APCO already cap their emissions of SO₂, NO_x and RSP; since 2005, the Government has been tightening the caps as the licences come up for renewal with a view to meeting emission reduction targets agreed with the Guangdong Provincial Government by 2010. What is new about the Bill is the proposal to allow Hong Kong's power companies to participate in an emission trading scheme under which they could buy emission credits giving them the right to emit additional amounts of pollution from their power plants in Hong Kong.

I have three concerns with the Bill:

1. The Administration is seeking to give effect to the "Implementation Framework of the Emissions Trading Pilot Scheme for Thermal Power Plants in the Pearl River Delta Region" (the Pilot Scheme) without drawing attention to serious flaws in its design.

¹ Sulphur dioxide (SO₂), nitrogen oxides (NO_x) and respirable suspended particulates (RSP)

2. The Bill would seriously weaken the legal duties that the APCO currently imposes on the Environmental Protection Department (EPD).
3. The Bill would take away the public's right to object to a proposed increase in the emission caps contained in a power plant's s.15 licence on the grounds that the increase might adversely affect air quality or be prejudicial to health.

Let me address each of these issues in turn.

Deficiencies of the Pilot Scheme.

Under the Pilot Scheme, all power plants in Hong Kong would initially be allocated a fixed number of emission allowances for each of the three controlled pollutants, which would be set at a level designed to allow the Hong Kong SAR Government to meet the 2010 emission reduction targets.² It would be an offence for Hong Kong power plants to emit more pollutants than the allowances granted to them unless they covered their excess emissions by buying surplus allowances from other power plants participating in the Pilot Scheme. [Bill, s. 26I] Power plants on the mainland would also be allocated emission allowances but on a different basis; the Base Emission Targets for many mainland power plants would vary according to their generated output, allowing pollution from power plants in Guangdong to increase in line with the growth in electricity demand.³

Emission trading schemes based on the "cap and trade" principle have worked well in the United States and elsewhere. In a cap and trade scheme, a fixed number of emission allowances are allocated to sources of pollution in a given area, limiting the quantity of specified pollutants they are allocated to emit over a given period; the total number of allowances would be set at a level designed to achieve the government's air quality objectives for that area. The allowances could then be traded by the holders so that those sources of pollution with the lowest pollution control costs could take on a larger share of the burden of achieving the required emissions reductions and split the cost saving with their trading partners. But the Pilot Scheme is not a cap and trade scheme; rather it is modelled on the controversial Clean Development Mechanism (CDM) for trading carbon credits. The CDM allows developing countries who are unwilling to impose firm caps on their own emissions to participate on a voluntary basis in carbon reduction schemes on a project by project basis in return for money and the transfer of technology.

According to the Stern Report on the Economics of Climate Change:

² LegCo Brief on the Air Pollution Control (Amendment) Bill 2008, paras 8-9.

³ Pilot Scheme, Appendix 2, para 3

“Project-based carbon finance acts as a form of subsidy; it reduces the emissions from a particular project, but it does not affect the demand for high carbon goods and services across the economy as a whole so the overall level of emissions can remain high or increase. It also creates issues of moral hazard and gaming, where there are incentives to manipulate the system to increase the rewards received (or reduce the costs paid).” [Stern Report, p. 572]

The same criticisms can be levelled at the Pilot Scheme. It does not affect the demand for electricity, which a major cause of worsening air quality in the region; the principal method of allocating emission allowances to power plants in Guangdong allows their emissions to increase in line with increases in their generated output. The Pilot Scheme could also create a disincentive for the Guangdong authorities to further tighten their legal controls over power plant emissions since that would foreclose a source of subsidy for Guangdong power plants that are in a position to profit by agreeing to make voluntary reductions in their emissions.

The EPD accepts that the Pilot Scheme is unlikely to result in any reduction in regional power plant emissions. An EPD official, David Wong, told the Advisory Council on the Environment (ACE) in March 2007 that the Scheme itself was not a pollution reduction measure but aimed to provide a more cost-effective framework for power companies to comply with their emission caps. [Minutes of Meeting held on 12 March 2007, para 7] The EPD has yet to acknowledge the risk of moral hazard and gaming that arises when trading occurs between two jurisdictions whose policies are poorly co-ordinated, but Mr Wong did assure the ACE that the Administration would examine very carefully the emission reduction plans submitted to it under the Pilot Scheme and would set limits on how far local power companies could rely on emission credits to meet their emission caps. [Minutes, para 25]. However, the only controls explicitly provided for in the Bill are audits under s. 26M to verify that sellers of emission credits have reduced their own emissions sufficiently to obtain the credits they have contracted to sell.

The Bill Seriously weakens the EPD’s Legal Duties

This leads to my second concern, the change that the Bill would make in the EPD’s legal duties to continuously improve air quality and safeguard public health. The trading of emission credits allows pollution to be shifted from the seller’s power plant to the buyer’s. People in Hong Kong will want to be reassured that there are legal safeguards in place to prevent trading under the Pilot Scheme from worsening air quality where they live and work. The Bill offers them no such assurance.

When the Director of Environmental Protection exercises his licensing powers under the APCO, he must “aim to achieve the relevant air quality objectives as soon as is reasonably practicable and thereafter to maintain the quality so achieved.” [APCO s.8(2)] In

setting the terms and conditions of those licences (including any caps on emissions), he must also:

- “(a) have regard to the capability of the applicant to provide and maintain the best practicable means for the prevention of the emission from his premises of any air pollutant;
- (b) have as his purpose the attainment and maintenance of any relevant air quality objective; and
- (c) have regard to whether the emission of noxious or offensive emissions would be, or be likely to be, prejudicial to health.” [APCO s. 15(3)]

If the Bill were enacted, the Director’s responsibility for limiting emissions would be transferred to the Secretary for the Environment. [Bill, s. 26G] In allocating emission allowances, the Secretary would be subject to duties similar to those imposed on the Director in s. 15(3), but with the significant difference that the Secretary’s allocation of allowances under s. 26G would only be provisional. The final allocation of the allowances would be determined in light of any trading in emission allowances and emission credits. By applying these duties only to the initial allocation of allowances, the Bill would effectively deprive them of any legal force.

The EPD official, David Wong, touched on this problem in the EPD’s March 2007 briefing of ACE on the Pilot Scheme. In responding to a concern that the Scheme might result in the importing of pollutants from Guangdong, he suggested that the EPD might impose two emissions caps on power plants; an “absolute cap” which power plants would never be allowed to exceed, regardless of how many emission credits they might buy, and a lower cap that power companies could achieve either by taking in-house measures or by purchasing emissions credits. [Minutes, para 24] None of this is reflected in the Bill. All indications are that the Administration regards the arrangements outlined in the Bill as replacing the existing system of fixed emission caps on individual power plants.⁴

How the EPD exercises its new statutory powers under the Bill may also be influenced by its non-statutory role as the Hong Kong power companies’ economic regulator under the Scheme of Control Agreements. The power companies are required to submit their Development Plans (which would include any planned expenditure to keep their emissions within legal limits) to the Government for its approval; the Government could leave the power companies with no option but to buy emission credits under the Pilot Scheme simply by withholding or even delaying approval of the necessary expenditures for them to use in-house measures to meet their emission reduction targets. At present the APCO requires the EPD to

⁴ Under Schedule 4 of the new Scheme of Control Agreements, the Permissible Emissions of the two power companies include emission allowances or emission credits obtained from third parties through trading.

regulate power plant emissions having regard to their effect on air quality and public health and the extent to which they can be prevented through the use of best practicable means. If the Bill is enacted, we can expect the Government's desire to prevent electricity tariffs from increasing to enter the equation.

Limits on the Public's Right to Object

Before the Director may grant a section 15 licence, the applicant must give notice of the application in an English language and a Chinese language newspaper and allow the public to inspect the application. [APCO s. 14] The public may object to an application on the grounds that it would tend to inhibit the attainment or maintenance of any relevant air quality objective or would be prejudicial to health. [APCO s. 14(4)(b)] The same notice and objection procedure applies when the holder of a licence applies to vary its terms and conditions and (if the Secretary so directs) when a licence is renewed. [s. 18(3), 16(3)] The Bill, however, does not offer the public any right to object to, or even be made aware of, proposals for allocating emission allowances to power plants in Hong Kong or applications to purchase emission credits, even though air quality may be adversely affected in the vicinity of the power plant that is acquiring additional credits.

The EPD has stated that one of its purposes in introducing the Bill is to enhance the transparency of how power plant emissions are to be controlled. [LegCo Brief, para 5] Its actual effect would be the opposite: a reduction in transparency and accountability from what is currently provided for in the APCO. That is a high price to pay for implementing what is supposed to be an experimental trading scheme. The Bill must not lose sight of APCO's primary aim, which is to bring about a steady improvement in air quality and protect public health. It should incorporate safeguards to ensure that trading is an effective means to that end and does not become an end in itself.

Whenever a Hong Kong power company proposes to enter into a contract to buy emission credits from a power plant in Guangdong, it should be required to give public notice of the application and provide basic particulars of its terms and its likely impact on the achievement and attainment of any relevant air quality objective. The EPD should make available its air quality model to allow applicants to predict the effect of shifting emissions from one power plant to another. The financial terms of the proposed trade should be disclosed to the public so that they will be aware of the true cost of controlling power plant emissions and be motivated (one hopes) to reduce power plant emissions by conserving energy.

The proposed trade should require the prior approval of the Director of Environmental Protection, who should be subject to the same duties as the Bill would impose on the Secretary under s. 26G(2). Before approving a trading contract, the Director should be required to take account of any objections to the trade made by members of the public. The

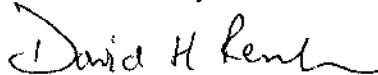
possibility of buying emission credits should not be a substitute for requiring power companies to use the best practicable means of preventing the emission of the relevant pollutants from their own power plants;⁵ where a power company proposes to buy credits, it should be required to explain why this is necessary notwithstanding its use of appropriate in-house measures. The applicant, but no one else, should have the right to appeal an adverse decision by the Director to the Appeals Board, but the public should be allowed (as it is at present) to challenge a decision of the Director by way of judicial review on the grounds that it is contrary to his statutory duties.

Conclusion

Emissions trading may become an important tool for achieving the Government's air quality targets in an economically efficient way. The Pilot Scheme (in spite of its deficiencies) may even prove to be a useful starting point for working towards an effective cross-border cap and trade scheme covering power plants in the Pearl River Delta Region. However, there is no immediate prospect of a cap and trade scheme being implemented until the mainland authorities are willing to control the energy demand and accept firm caps on at least some pollutants.

The Pilot Scheme, like the CDM it is modelled on, is designed to allow governments with different environmental policies to work together on specific emission reduction projects. We in Hong Kong, however, must be mindful of the risk that our environmental standards (lax as they are) could be further weakened by participating in a cross-border trading scheme with a much bigger trading partner whose environmental standards are even laxer than ours. The Bill should reaffirm the legal safeguards contained in the APCO, not jettison them in the interests of implementing a "lowest common denominator" approach to emissions trading.

Yours sincerely



David Renton
Partner

⁵ The "polluter pays" principle would suggest that the cost of electricity in Hong Kong should reflect the cost of using the best practical means of preventing the emission of pollutants just as it reflects the cost of the turbines and other components of power plants. The Administration does not seem to subscribe to this view — its policy is to avoid the costs of pollution control facilities being passed on to consumers as far as possible. Stage II Consultation Paper on Future Development of the Electricity Market in Hong Kong, para 2.53 (December 2005). This may be one reason why its efforts to improve air quality have been so ineffective.