For information on
25 November 2013

Legislative Council Panel on Economic Development

Scheme of Control Agreements (SCAs) with the Power Companies
2013 SCA Mid-term Review

INTRODCUTION

This paper informs Members of the outcome of the mid-term review of the Scheme of Control Agreements ("SCAs") undertaken in 2013 pursuant to the SCAs ("2013 SCA Mid-Term Review").

BACKGROUND

2. The Government signed two SCAs in January 2008, one with CLP Power Hong Kong Limited ("CLPP"), ExxonMobil Energy Limited and Castle Peak Power Company Limited ("CAPCO"), and the other with The Hongkong Electric Company, Limited ("HEC") and Power Assets Holdings Ltd (formerly known as Hongkong Electric Holdings Limited). CLPP and CAPCO are collectively referred to as "CLP", while CLP and HEC are collectively referred to as "two power companies" hereunder. The SCAs respectively set out the returns in respect of electricity-related[1] operations for shareholders of CLP on the one hand, and HEC on the other, and the arrangements by which the Government monitors their financial affairs in so far as they are electricity-related. The current SCAs run for a term of ten years and will expire in 2018, with an option exercisable by the Government to extend the term for five years until 2023. Each of the SCAs stipulates that any of the parties may during 2013 request modification of any part of the current SCAs, but all proposed modifications will not take effect unless a written agreement is made by all parties on the modifications.

[1] Activities that are directly or indirectly appertaining to the generation, transmission, distribution, sale of electricity, energy efficiency and conservation, or emissions reduction are regarded as "electricity-related" for the purposes of the SCAs and this paper.

THE 2013 SCA MID-TERM REVIEW

3. To prepare for the 2013 SCA Mid-Term Review, we have engaged experts, academics, green groups and other stakeholders to solicit their comments and suggestions. We consulted the Legislative Council Panel on Economic Development at its meeting in November 2012, and attended its meeting in February 2013 to listen to the views of various deputations and Panel members. We also consulted the Energy Advisory Committee[2] in November 2012.

4. Having regard to the public views, our experience in operating the SCAs in the past few years and latest economic conditions, we put forward various proposals for modifying the SCAs to the two power companies, with a view to seeking improvements on the terms and conditions of the SCAs, thereby enhancing benefits to the consumers. These proposals fall broadly into the following areas –

(i) To reduce the Permitted Return;
(ii) To rationalise fixed assets disposal arrangements;
(iii) To promote energy efficiency;
(iv) To improve the incentives/penalties schemes;
(v) To better regulate Tariff Stabilisation Fund ("TSF") balance;
(vi) To enhance accountability and transparency; and
(vii) To rationalise certain accounting arrangements.

Agreement Reached

5. The two power companies have agreed in principle to certain modifications to be made to the SCA under the 2013 SCA Mid-Term Review. The modifications so agreed are as summarised in the ensuring paragraphs 6 to 14.

Energy efficiency

6. The two power companies have agreed to each set up an energy efficiency fund ("Energy Efficiency Fund") out of shareholders' earnings to provide, subject to a ceiling, subsidies on a matching basis[3] to

[2] The Energy Advisory Committee is a non-statutory committee which advises the Government on energy policy, including policy matters concerning energy supply and demand, energy conservation and efficiency, and other related matters referred to it by the Government.

[3] By "matching basis", it is meant that the cost of the improvement works will be shared by the owner and the relevant power company on an equal basis subject to the ceiling of subsidy.

non-commercial building owners to carry out improvement works to enhance the energy efficiency of their buildings, with priority to be given to single residential blocks. Specifically, the two power companies have agreed to pay into the Energy Efficiency Funds amounts equal to the financial incentive payments that they will from time to time receive under the energy efficiency incentive mechanism in the SCAs for outperforming the energy audits and energy saving targets set for each of the years from 2014 until expiry of the current term of the SCAs. Based on the records of the two power companies in earning the relevant financial incentives in the past few years, it is estimated that some $100 million in total may be injected into the Energy Efficiency Funds to support energy improvement projects. Details of the scheme are being drawn up by the two power companies. It is expected that each of the two power companies will launch its scheme in the first half of 2014.

7. In addition, the two power companies have agreed to extend the current interest-free loan fund ($25M for CLP per annum and $12.5 million for HEC per annum)[4] for a further period of five years from the original expiry date of the loan fund under the SCAs to their non-Government customers to implement energy-saving initiatives identified in the energy audits to promote energy efficiency.

Higher targets for supply reliability, operational efficiency and customer services

8. Under the existing SCAs, the two power companies will be awarded incentives or will have to pay penalties for their performance in respect of supply reliability, operational efficiency and customer services. For each of the two power companies, the actual amount of incentive payment and penalties are calculated by reference to a certain percentage of Average Net Fixed Assets value[5] ("ANFA") of the power company. In pursuit of continuous improvement in the above areas, the Government and the two power companies have agreed to raise the performance thresholds for both the incentive payment and penalty in all of the above aspects.
Annex Detailed changes are described at Annex.

[4] Under the current terms of the SCAs, CLP and HEC have agreed to set up a loan fund for a five-year period (amounting up to $125 million for CLP and $62.5 million for HEC for the whole of the five-year period from the commencement of the SCAs) to provide loans to non-Government customers to implement energy saving initiatives identified in energy audits to promote energy efficiency.

[5] In relation to the two power companies, "Average Net Fixed Assets" in relation to a year covered by the relevant SCA means the average for that year of the opening and closing balances of the Net Fixed Assets. "Net Fixed Assets" means cost of CLP's or HEC's electricity-related investments in land, buildings plan, equipment, and capitalised refurbishment and improvement works and other assets specified in the relevant SCA less depreciation to be calculated in accordance with the provisions of that SCA.

TSF balance

9. Each of the two power companies has agreed to lower the cap on the TSF balance from 8% to 5% of its annual total revenues from sales of electricity to consumers in Hong Kong. This arrangement will ensure that balance of the fund can be used to alleviate the impact of tariff increase on customers as soon as possible. We consider that the level of the new cap is reasonable and bringing it down further could weaken the ameliorating function of the TSF.

Transparency of the annual Tariff Review

10. The two power companies have agreed to promote transparency of their operation by providing more information to the public. It will be made a requirement that certain financial and operating data relating to the latest approved Development Plan and the proposed tariff adjustments for the upcoming year, including capital expenditure forecast, projected year-end balance of Tariff Stabilisation Fund and Fuel Clause Recovery Account, analysis of tariff adjustments, etc. will be published by the two power companies upon the conclusion of an annual Tariff Review exercise, and a dedicated website to disclose such information will be set up.

Extension of asset useful life

11. CLP has agreed to extend the depreciation period of certain transmission and distribution fixed assets to better reflect their useful life. Specifically, the useful life of its overhead lines (at 33kV and above) will be extended from 50 to 60 years, the useful life of cables (at 132kV and above) will be extended from 55 to 60 years, and the useful life of buildings and civil structures (other than cable tunnels and those at power stations) will be extended from 50 to 60 years. This will bring the useful lives of such assets on par with the useful life of the same categories of fixed assets of HEC, and is expected to bring about savings of about $350 million for CLP consumers from 2014 to 2018.

Removal of Emissions Performance Linkage Mechanism

12. Under the "Emissions Performance Linkage Mechanism" ("EPLM") in the SCAs, the two power companies will be awarded up to 0.1% incentive for outperformance or imposed up to 0.4% penalty for underperformance, calculated based on ANFA minus Average Renewables Net Fixed Assets ("ARNFA")[6] for that year. With the effective operation of the Technical Memoranda[7] under the Air Pollution Control Ordinance (Cap. 311 of the Laws of Hong Kong) in emission control, we have proposed to the two power companies to remove the EPLM. CLP has agreed to this proposed removal. HEC does not agree and its reasoning is set out in paragraph 22.

Accounting Arrangements

(a) Rate Reduction Reserve

13. To ensure prompt and timely use of the Rate Reduction Reserve (RRR)[8] for the benefit of customers, the two power companies have agreed to modify the SCA to streamline the administration of the RRR starting from end 2013, such that the year-end balance of the RRR of a year will be transferred to the TSF in the subsequent year.

(b) Cost of pre-project studies and assessments

14. Under the current arrangement, HEC capitalises pre-project studies and assessments for calculation of Permitted Return upon

[6] In relation to each of the two power companies, "Average Renewables Net Fixed Assets" in relation to a year covered by the relevant SCA means the average for that year of the opening and closing balances of the Renewables Net Fixed Assets. "Renewables Net Fixed Assets" means cost of the two power companies' Net Fixed Assets (see Footnote 5 above) in so far as attributable to their respective renewable energy infrastructure investments within Hong Kong including those Renewable Energy Systems and dedicated transmission and distribution assets that are used for connecting such Renewable Energy Systems to the main electricity grid.

[7] The Air Pollution Control Ordinance (Cap.311) was amended in July 2008 to add, inter alia, Section 26G. Section 26G(1) of Cap.311 provides that the Secretary for the Environment shall by technical memorandum allocate a quantity of emission allowances for each type of specified pollutant in respect of each specified licence (i.e. setting emission caps) as stated thereunder. Non-compliance with these emission caps is an offence liable on a first conviction, to a fine of $30,000 in respect of each tonne of exceedance; and on a second or subsequent conviction, a fine of $60,000 in respect of each tonne of exceedance plus imprisonment for 6 months.

[8] RRR is an account to which in each year, an amount equals to a specified interest rate times the average of the opening and closing balances the TSF for that year is credited. Under the current SCAs, RRR shall be reduced by rebates applied to the tariffs normally in the next following year so as to effect tariff reductions or to minimise tariff increases. Under the SCAs, the balance of the RRR shall not exceed the total annual amount credited to the RRR for the then current year and the preceding three years whether covered by the term or not.

commencement of such studies or assessments. It has now agreed to align with CLP by putting relevant expenditures in a separate suspense account first, and to count them as fixed assets for earning Permitted Return only after a decision is made to proceed with the projects. This will avoid providing a return on those projects which may not proceed at the end.

Point of Dissent

15. Notwithstanding the above improvements, the two power companies have maintained their basic position that no fundamental changes to the SCAs should be made during the 2013 SCA Mid-Term Review, and do not agree to some of the changes proposed by the Government. These rejected proposals are set out in the ensuing paragraphs. In the absence of agreement by the other parties, no changes can be introduced to the SCAs in relation to these rejected proposals.

Permitted Rate of Return

16. Having regard to the latest economic environment, we have proposed to the two power companies that the Permitted Rate of Return on both ANFA and ARNFA (currently at 9.99% and 11% respectively) be reduced. The two power companies do not accept the proposal. They consider that the prevailing economic and monetary environment is volatile and prone to changes. Given the 10-year tenure of the SCA and the long-term nature of their investments, the two power companies consider that changing the Permitted Rate of Return at this juncture would be a substantial regulatory risk inconsistent with the principle of contract sanctity, and have a significant impact on the planning, financing and delivery of electricity service.

Excess capacity

17. The two power companies do not agree to our proposal to tighten the mechanism for treating excess generating capacity by excluding any generating unit that fails the excess capacity test from earning the Permitted Return. They consider that due diligence had been exercised before they committed capital investments in the generating capacity. They are also of the view that the current penalty mechanism, which excludes 50% of the mechanical and electrical equipment cost of the generating unit from ANFA for calculating the Permitted Return, is appropriate given their obligations

to ensure supply reliability and the increasing risks associated with demand forecasts due to more extreme weather conditions.

Emission control facilities

18. Given that emission standards are governed by law and it is the two power companies' responsibility to meet their statutory obligations, we have proposed to exclude investments in any new or existing emission control facilities from earning Permitted Return. The two power companies do not agree to our proposal. They consider that emission control facilities form an essential and inseparable part of their power generating facility, and can bring substantial environmental benefits to consumers. As such, they should be considered as electricity-related in accordance with the SCAs and accounted for as part of the fixed assets**.**

Capital gain out of disposal of fixed asset

19. The two power companies reject our proposal for them to return to consumers 50% of the capital gain out of their disposal of fixed assets if the proceeds exceed the original costs. They consider that the current arrangement, whereby the difference between original and net book value of the fixed assets will be deducted from the Total Operating Costs, has already helped reduce tariff and benefit consumers. It has already provided "a reasonable split between customers and shareholders in fixed assets disposal".

Approval mechanism of Tariff adjustments

20. We have proposed that prior approval from the Executive Council be obtained if tariff increase exceeds Composite Consumer Price Index (CCPI). However, the two power companies do not agree for reason that the existing tariff review and approval mechanism has already allowed the Government to exercise effective scrutiny over tariff adjustments. Under the existing arrangement, the two power companies have to submit Development Plans, which set out the projected Basic Tariff Rate for each of the years covered by the Development Plan[9], for the Executive Council's approval. In October each year, the Government and each of the two power companies will also jointly conduct a Tariff Review. If following the Tariff Review, any subsequent proposed adjustment of the Basic Tariff

[9] Each Development Plan shall cover a period of at least 5 successive years after the year of submission of the Plan or the remaining term of the SCA, whichever is shorter.

Rate for a year covered by an approved Development Plan does not exceed 5% of the projected Basic Tariff Rate most recently approved for that year by the Executive Council, no approval of the Executive Council is required for the adjustment. However, if a proposed adjustment of the Basic Tariff Rate for a year covered by an approved Development Plan exceeds 5%, approval of the Executive Council is required whether or not a new Development Plan is involved.

21. The two power companies also consider that given tariff is affected by fuel costs and other costs subject to fluctuations in international markets, linking tariff adjustments to local CCPI is not justified.

Removal of Emissions Performance Linkage Mechanism

22. HEC does not accept our proposal to remove the EPLM. It considers that the existing incentive and penalty mechanism is a key driver for HEC to continue its efforts to minimise emissions.

Conclusion

23. The modifications summarised in paragraphs 6 to 14 above represent a package that we could best achieve given the remit of the SCAs. This package of modifications will bring some degree of material benefits to electricity consumers. While certain changes proposed by the Government in the context of the 2013 SCA Mid-Term Review are rejected by the two power companies, we will take into account the views and comments received when conducting an overall review of the future regulatory framework for the electricity market after expiry of the current SCAs. This overall review will be conducted in 2014 as a separate exercise.

Implementation

24. Each of the SCAs requires written agreement to be made by all parties to that SCA to give legal effect to any modification of the provisions of the SCA. We will arrange for the preparation and execution of written agreements to be made with the other parties to the SCAs on the modifications summarized in paragraphs 6 to 14 above. The written agreements will set out the detailed terms of such modifications as agreed by all parties and will take immediate effect upon execution by all parties.

Advice Sought

25. Members are invited to note the content of this paper.

Environment Bureau
November 2013

Annex

Comparison of the current performance thresholds under the SCAs and revised performance thresholds

Customer Performance Category	**Performance Index**	**Current Target**	**New Target**	**Incentive Adjustment (% of Total ANFA)**
Supply Reliability	Average Service Availability Index (ASAI)	ASAI is greater than or equal to 99.992% (i.e. the average interruption time of supply is less than or equal to 42 minutes/year)	ASAI is greater than or equal to 99.995% (i.e. the average interruption time of supply is less than or equal to 26 minutes/year)	+ 0.01%
		ASAI is less than 99.992% but more than 99.985% (i.e. the average interruption time of supply is longer than 42 minutes/year but less than 79 minutes/year)	ASAI is less than 99.995% but more than 99.99% (i.e. the average interruption time of supply is longer than 26 minutes/year but less than 53 minutes/year)	0%
		ASAI is equal to or less than 99.985% (i.e. the average interruption time of supply is longer than or equal to 79 minutes/year)	ASAI is equal to or less than 99.99% (i.e. the average interruption time of supply is longer than or equal to 53 minutes/year)	- 0.01%

Customer Performance Category	Performance Index	Current Target	New Target	Incentive Adjustment (% of Total ANFA)
Operational Efficiency	Connection & Supply Performance Index (CSPI)	CSPI is equal to 100% (i.e. the permitted number of failures of making available the power supply by the power company within the same day of the inspection of installations is zero)	CSPI is equal to 100% (i.e. the permitted number of failures of making available the power supply by the power company within the same day of the inspection of installations is zero)	+ 0.01%
		CSPI is less than 100% but more than 99.95% (i.e. the permitted number of failures of making available the power supply by the power company within the same day of the inspection of installations is more than zero but less than 5 in 10,000 cases)	CSPI is less than 100% but more than 99.98% (i.e. the permitted number of failures of making available the power supply by the power company within the same day of the inspection of installations is more than zero but less than 2 in 10,000 cases)	0%
		CSPI is equal to or less than 99.95% (i.e. the number of failures of making available	CSPI is equal to or less than 99.98% (i.e. the number of failures of making available the	- 0.01%

Customer Performance Category	Performance Index	Current Target	New Target	Incentive Adjustment (% of Total ANFA)
		the power supply by the power company within the same day of the inspection of installations is at the ratio of 5 or more in 10,000 cases)	power supply by the power company within the same day of the inspection of installations is at the ratio of 2 or more in 10,000 cases)	
Customer Services	Appointment Punctuality Index (API)	API is greater than or equal to 98% (i.e. rate of punctual attendance of installation inspection is at the ratio of 980 or more in 1,000 cases)	API is greater than or equal to 99.7% (i.e. rate of punctual attendance of installation inspection is at the ratio of 997 or more in 1,000 cases)	+ 0.01%
		API is less than 98% but more than 96% (i.e. rate of punctual attendance of installation inspection is at the ratio of less than 980 in 1,000 cases but more than 960 in 1,000 cases)	API is less than 99.7% but more than 98% (i.e. rate of punctual attendance of installation inspection is at the ratio of less than 997 in 1,000 cases but more than 980 in 1,000 cases)	0%

Customer Performance Category	Performance Index	Current Target	New Target	Incentive Adjustment (% of Total ANFA)
		API is equal to or less than 96 % (i.e. rate of punctual attendance of installation inspection is at the ratio of 960 or less in 1,000 cases)	API is equal to or less than 98% (i.e. rate of punctual attendance of installation inspection is at the ratio of 980 or less in 1,000 cases)	- 0.01%