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**Panel on Economic Development**  
**Meeting on 25 November 2013**

**Background brief on**  
**Scheme of Control Agreements with the two power companies**  
**– interim review in 2013**

**Purpose**

This paper sets out the background of the interim review of the Scheme of Control Agreements ("SCAs") being conducted by the Government with the two power companies and summarizes Members' concerns on related issues.

**Scheme of Control Agreements**

2. Electricity supply in Hong Kong is regulated through SCAs signed between the Government and individual power companies, namely, The Hongkong Electric Company Ltd. ("HEC")<sup>1</sup> which supplies electricity to customers on the Hong Kong Island, Ap Lei Chau and Lamma Island, and CLP Power Hong Kong Ltd. and Castle Peak Power Company Ltd. ("CAPCO")<sup>2</sup> (referred to collectively as "CLP" hereafter) which jointly supply electricity to customers in Kowloon and the New Territories including Lantau, Cheung Chau and some outlying islands. SCAs set out the rights and obligations of the power companies and provide a framework for the Government to monitor the power companies' financial affairs and technical

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<sup>1</sup> HEC is a subsidiary of Power Assets Holdings Limited.

<sup>2</sup> CLP Power Hong Kong Ltd. is a subsidiary of the CLP Holdings Limited. CAPCO is a joint venture electricity generating company established between CLP Power (40%) and ExxonMobil Energy Limited (60%).

performance. To achieve the policy objective of providing reliable, safe and efficient electricity supply at reasonable prices, SCAs include the following key features –

- (a) an obligation for the power companies to provide sufficient facilities to meet present and future electricity demand;
- (b) an obligation for the power companies to supply electricity at lowest possible cost; and
- (c) provision for periodic financial review and annual tariff review, and for annual audit of the technical and financial performances of the power companies.

3. The existing SCAs were entered into between the Government and individual power companies on 7 January 2008, with the following major terms –

- (a) the term of SCAs is ten years (shortened from 15 years in previous SCAs), with an option exercisable by the Government to extend by five years, i.e. until 2023;
- (b) the annual permitted rate of return is 9.99% (reduced from 13.5% to 15% previously) on the average net fixed assets ("ANFA") of the power companies;
- (c) the power companies' permitted rate of return is linked to their emission performance. A penalty level at, respectively, 0.4 and 0.2 percentage points reduction of return on all non-renewable energy fixed assets will be imposed if the power companies exceed any of the emission caps of  $\geq 30\%$  and  $\geq 10\%$ , respectively. They will be given a smaller financial incentive at 0.1 and 0.05 percentage points increase of rate of return for over-achievement of all the emission caps of  $\geq 30\%$  and  $\geq 10\%$  respectively;
- (d) financial incentives are provided to encourage more usage of renewable energy;
- (e) the portion of the net asset value on machinery and electrical equipment relating to new generating facility found to be excessive upon commissioning for exclusion from the company's ANFA for calculating the return is set at 50% for both power companies (previously 40% for CLP and 50% for HEC);

- (f) the threshold above which the Executive Council's approval is required for adjustment of the Basic Tariff is 5% (lowered from 7% in the previous SCAs), limiting the room for the power companies to adjust their tariffs;
- (g) a Tariff Stabilization Fund ("TSF") is maintained for the retention of net revenue in excess of the agreed return for the power companies and the cap on TSF balance is 8% of annual local sales (down from 12.5% in the previous SCAs);
- (h) the Government will have unfettered discretion to introduce changes to the electricity regulatory framework, starting 1 October 2018 for CLP and 1 January 2019 for HEC, after taking into consideration market readiness and other relevant factors. The changes may include the introduction of legislation to replace the SCAs regime; and
- (i) in the event of a change implemented by the Government to the electricity supply market structure that caused material impact to the power companies, they shall recover from the market stranded costs that could not be mitigated by measures required by the Government.

#### Interim review of the SCAs

4. In accordance with the SCAs, the Administration started the interim review of the SCAs with the two power companies in January 2013. Any changes to the SCAs are to be mutually agreed by the Administration and the power companies.

#### **Discussions held by the Panel on Economic Development**

5. The Panel on Economic Development ("the Panel") received briefing by the Administration on the interim review of SCAs with the two power companies at the meeting on 26 November 2012, and received deputations' views on the matter at the meeting on 25 February 2013.

#### Matters for inclusion in the review

6. Members queried about the criteria used to assess the permitted rate of return, the emission performance, energy efficiency, the use of renewable energy, etc. of the two power companies in the interim review. The

Administration advised that the permitted rate of return for the two power companies was set having regard to factors, such as the advice from experts, and the return for similar industries in other countries. There were also provisions in SCAs encouraging the two power companies to promote energy efficiency.

7. Some members suggested that the Administration should make use of the interim review to discuss with the power companies regarding issues such as the fuel mix for electricity generation, the level of the permitted rate of return, the pegging of the rate of return to the power companies' fixed assets, the interconnection of the transmission networks of the two power companies, as well as the possibility of opening up the electricity market and the arrangement for the resultant stranded costs. One member stressed that the crux of the SCA review was the downward adjustment of the permitted rate of return as consumers would still have to pay a high electricity tariff if the permitted rate of return of 9.99% for the power companies remained unchanged.

8. The Administration advised that it would discuss with the power companies issues such as energy saving measures, the fuel mix for electricity generation, emission performance, as well as the permitted rate of return during the interim review of the SCAs in 2013 and the overall review before 2016. As regards stranded costs, the Administration advised that the power companies would be allowed to recoup such costs from the market if the Government implemented change in the electricity market structure in 2018.

#### Opening up of the electricity market

9. Some members expressed concerns on whether the Administration would consider introducing competition in the electricity market in 2018, and, if so, whether preparatory work would be carried out during the SCAs interim review in 2013. One member enquired whether the Government would consider regulating the electricity market by legislation instead of SCAs. The Administration advised that it did not have a fixed view on introducing competition in the electricity market, and the issue of opening up the electricity market would not be considered during the interim review of SCAs in 2013. The Administration had to discuss with the two power companies as early as possible and not later than 2016 on any changes to the regulatory framework of the electricity market.

10. Members also enquired whether the Administration would liberate the electricity market by separating power generation and transmission to facilitate market entry. The Administration advised that it did not have a fixed view regarding the interconnection of the power networks of the two

power companies in the supply of electricity, but certain technical issues would have to be resolved before the networks of the two power companies could be connected. The Administration had also advised that the issue would be considered in the context of the overall review of the current SCAs.

### Fuel mix and use of nuclear energy

11. Some members expressed concern about whether the interim review of SCAs would include the fuel mix for electricity generation. Other members suggested that the Administration should have a clear policy on the fuel mix for electricity generation so as to minimize power companies' investments in pollution-reduction facilities which might drive up electricity tariffs. In this connection, members had mixed views on the use of nuclear energy in the fuel mix. Some members expressed concerns on the use of nuclear energy and enquired about the Administration's policy on safety and contingency measures in the event of nuclear incidents. One member commented that power companies should refrain from purchasing electricity from the nuclear plants in Guangdong, but should fund more research on the adverse impact of nuclear energy. Another member enquired whether the Administration would explore the possibility of introducing shale gas as fuel of electricity generation in Hong Kong.

12. The Administration advised that views were split among different stakeholders on the use of nuclear energy for electricity generation. Extensive consultation would need to be conducted, and the Administration would have to assess these views in reviewing the fuel mix with the power companies. As regards the use of shale gas, the Administration advised that the option would be explored, but technical issues relating to production and transportation would have to be resolved before shale gas might be brought into Hong Kong.

13. On fuel mix, some members enquired about the impact on electricity tariff increase due to increase in fuel costs for implementing a fuel mix of nuclear energy, natural gas and coal at 50%, 40% and 10%, respectively, as proposed in the Hong Kong's Climate Change Strategy and Action Agenda Consultation Document published in 2020. The Administration was unable to make an estimate due to the uncertainties in the price of coal and natural gas which was subject to international market fluctuation and the difficulties in determining the investment costs in the infrastructure for importing more nuclear electricity.

### Public consultation

14. Some members commented that the public should be consulted on all

matters relating to the supply of electricity, such as the proposals to use progressive or regressive tariff structures, imposing different tariff rates for different periods of the day, restrictions on lighting during evenings, change of the energy mix for electricity generation, and the use of nuclear energy. The Administration advised that all parties concerned would be consulted in reviewing SCAs, and that the Panel would be consulted when the Government had formulated the regulatory framework for the electricity market.

#### Energy efficiency and surplus generating capacity

15. Some members considered the current SCAs over-generous as the two power companies were given a permitted rate of return of 9.99% on their fixed assets as well as financial incentives for performance improvement measures on energy efficiency, operational efficiency, supply reliability and customer services. They suggested that the financial incentives should be used to support the Tariff Stabilization Fund instead. The Administration confirmed that it would review the arrangement of providing financial incentives to the power companies for improvement in the performance of energy efficiency.

16. Members queried the justifications for the two power companies to maintain a 30% to 50% reserve capacity. The Administration explained that the total installed capacity of the power companies had to be higher than the forecast maximum demand at any time in order to satisfy the demand of electricity in a secure and reliable manner, with a margin of reserve to cater for system contingency and allow shutting down of generating units for maintenance and repair.

17. Noting that CLP continued to increase the amount of electricity supplied by the Daya Bay nuclear plant, some members expressed concern whether the generation units of the power company in Hong Kong might become excessive. Some other members queried why the company had to sell surplus electricity to the Mainland when it was purchasing electricity from the Daya Bay nuclear plant. The Administration advised that CLP only made use of its reserve generation capacity in selling electricity to the Mainland, and that in the development plans for 2009 to 2014, the Administration had not approved the development of any new generation facilities for the two power companies for the purpose of selling electricity to other places.

## **Latest developments**

18. At the meeting of the Legislative Council held on 6 November 2013, a member raised a question relating to the alleged over-estimation of fuel cost surcharge by CLP which might lead to over-charging of electricity consumers. The question also touches on issues such as liberation of the electricity market and the effectiveness of energy saving measures in reducing air pollution.

19. The Administration will inform the Panel at the meeting on 25 November 2013 of the results of the interim review in 2013 of the SCAs.

## **References**

20. A list of the relevant papers is as follows –

Background brief on Scheme of Control Agreement with the power generation

<http://www.legco.gov.hk/yr12-13/english/panels/edev/papers/edev1126cb1-189-4-e.pdf>

Minutes of meeting of the Panel on Economic Development held on 26 November 2012

<http://www.legco.gov.hk/yr12-13/english/panels/edev/minutes/edev20121126.pdf>

Minutes of meeting of the Panel on Economic Development held on 25 February 2013

<http://www.legco.gov.hk/yr12-13/english/panels/edev/minutes/edev20130225.pdf>

The Administration's paper on the Scheme of Control Agreements with the two power companies – interim review in 2013

<http://www.legco.gov.hk/yr12-13/english/panels/edev/papers/edev1126cb1-189-3-e.pdf>