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[Home \(/\)](#) > Regulatory risks cast shadow on HK Electric deal

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Business > **Companies INVESTMENT**

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Proposed spin-off of utility offers good initial return but examination of scheme of control points to further cut in allowed annual return

Li Ka-shing's utilities flagship, Power Assets Holdings, has lit up the planned spin-off of its Hong Kong electricity supply operation with an attractive return, but its prospects are being darkened by growing regulatory risks.

Power Assets, which has gas and electricity interests around the world, plans to divest 50.1 per cent to 70 per cent of wholly owned Hongkong Electric - the sole supplier of power to customers on Hong Kong and Lamma islands since 1890 - to a newly created trust. The trust, known as HK Electric Investments and valued at HK\$48 billion to HK\$63.4 billion, aims to debut on the Hong Kong stock exchange next month.

Some analysts and academics said the annual yield offered by HK Electric Investments, ranging from 5.5 per cent to 7.3 per cent in the first year of listing, was attractive compared with overseas utilities.

The return based on investments in assets is dreadfully outdated

FRED LI, LEGISLATOR

However, the scheme of control regulatory regime that governs HK Electric and the other electricity firm in the city, CLP Power, is set for review in 2018, with negotiations between the government and the utilities due next year.

"The future return is likely to be cut and the way to calculate the return is likely to be modified," said William Chung Siu-wai, a director of City University's Energy and Environmental Policy Research Unit.

Some analysts said acquisitions of gas and power projects in Britain, Australia, New Zealand and Canada in the past few years showed Power Assets was trying to mitigate rising regulatory risks on its home turf.

In Hong Kong, HK Electric and CLP are allowed to earn an annual return of up to 9.99 per cent of their average net fixed assets in use, which means their profits are tied to investments in power assets such as generation, distribution and transmission facilities. This return was cut from 13.5 per cent to 15 per cent in 2008.

Chung said he expected the post-2018 return could be lowered to about 7 per cent, which is about the industry average overseas.

Former Polytechnic University professor Lam Pun-lee said that in the coming five years HK Electric would be able to earn the 9.99 per cent permitted return after the government granted a 7.4 per cent - or 7.1 HK cents - rise in the basic tariff per kilowatt hour from the start of next year. The basic tariff rise was offset by a cut in the fuel surcharge of 7.1 HK cents per kWh, leaving the total tariff unchanged.

Democratic Party legislator Fred Li Wah-ming, also a member of the Consumer Council's ad hoc group on the electricity market, urged the government to overhaul the regulatory mechanism in 2018. "The return based on investments in assets is dreadfully outdated," he said. "It worked well 20 or 30 years ago, when the city needed electricity infrastructure. The post-2018 regulatory regime must be reformed."

Li proposed ditching the existing return in favour of a return based on a basket of factors including the cost of capital and Hong Kong's inflation rate.

He also said that instead of vertically integrated businesses - spanning electricity generation, distribution and transmission - the two power firms should split the ownership of their power grids from electricity generation.

The mainland's power market underwent such reform almost a decade ago.

Raymond So Wai-man, chairman of the Environment Bureau's energy advisory committee, said the post-2018 governance mechanism would be "a complicated, not easy" task.

So said the government would have to determine which factor should come first - environmental impact, tariffs or the reliability and stability of electricity supply.

Power Assets shares jumped 70 HK cents, or 1.18 per cent, to HK\$59.65 yesterday.

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