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Copy The Honourable Tse Chin-wan; BBS, JP
Secretary for Environment and Ecology

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(by e-mail)

Dear Financial Secretary,

2023 Budget Consultation Recommendations

Last year our recommendations for your budget year focused on the action needed given Climate Change. In the year since, scientific warnings of the threats from climate change have become clearer while the global response remains inadequate. The consequences of this include:

- The transition to the global Net Zero economy, which is required to stop increasing global temperatures, will have to be faster and hence more disruptive and expensive.
- Substantial sums must be spent on adapting to rising sea levels and changes in the climate.

The size of the expenditure on this issue was noted in the \$240 billion budget in the next 15 to 20 years advised in the 'Policy Measures' publication which accompanied the October 2022 Policy Address¹. We kindly ask that your budget provide a breakdown of this total by year and activity. In addition, we recommend your budget to advise measures in the next three years to accelerate action on climate change. In particular:

- Fiscal policy action to reduce economic risks and take advantage of opportunities associated with the global transition to Net Zero. – See [attachment 1](#)
- Infrastructure funding to respond to the physical risks due to climate change. – See [attachment 2](#)
- Action to support Hong Kong's Financial Services participating in Just Energy Transition Partnerships (JETP). This can both boost Hong Kong's income from this

¹ Policy Measures – Page 64: Allocate sufficient resources, estimated to be about \$240 billion in the next 15 to 20 years, to support mitigation and adaptation measures for combating climate change. www.policyaddress.gov.hk/2022/public/pdf/measure/Policy-Measures-full-en.pdf

sector and make an important contribution to accelerating decarbonising the electricity supply in lower income countries. – See attachment 3

We appreciate you have many other considerations when preparing the budget and may not be ready to announce some policies in the forthcoming budget. If so, it would be helpful, if you can note the importance of these three areas and advise action being taken to study them.

We are copying The Honourable Tse Chin-given his department is leading much of the work which needs the support of the fiscal measures we describe.

Yours sincerely,



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Attachment 1: Recommendation that fiscal policy includes the objective of reducing economic risks associated with the global transition to Net Zero

As noted in the covering letter, the global transition to Net Zero carbon emissions poses great opportunities and risks to Hong Kong's economy. Fiscal Policy action should therefore be taken to reduce these risks while taking advantage of the opportunities.

Anticipating changes in Hong Kong's economy

First, we recommend financial modelling should be done to determine which sectors of Hong Kong's economy may grow and which are likely to shrink due to the transition to Net Zero. For example, we expect:

1. Discretionary high-carbon activity such as using Cruise Ships and taking long distance air-travel for a vacation will substantially reduce.
2. The role of Financial Services in funding the transition in APAC and in carbon markets will increase. – See [attachment 3](#) for an example.

Carbon pricing

Since the Stern Report in 2006², considerable attention has been paid to motivating decarbonisation by putting a price on carbon. We recommend studying introducing carbon pricing in Hong Kong given the following developments:

1. China's National Carbon Trading scheme is now operating for its power sector and is expected to expand to more sectors of its economy. Considerations on whether Hong Kong's should link to it include:
 - a. Trade between Hong Kong and the Mainland will flow more freely if they have the same carbon pricing scheme.
 - b. With a link to a large market the cost of decarbonising Hong Kong is expected to reduce.
 - c. China's scheme is still in its formative stage and may be subject to policy changes which could be disruptive.
2. Following reform over the last few years the European Union's Emissions Trading Scheme now has a substantial price of close to US\$100/tCO₂e. The European Union thus has the problem that its imports have the advantage over its domestic production of not paying the carbon price. It currently removes the advantage imports have by giving carbon intense industries such as cement and steel an allocation of free credits. That, however, undermines their incentive to decarbonise. The European Union will therefore shortly announce a 'Carbon Border Adjustment Mechanism' (CBAM) to charge imports for the difference between the carbon price in the European Union and the carbon price in the country from which goods are imported. This will leave other countries in the following position:

² The Economics of Climate Change: The Stern Review

- a. If they do not have a carbon price the European Union will collect the CBAM charge with the funds going to its Treasury.
 - b. If they have a carbon price, they will receive the funds from applying it.
3. Some other countries already have a carbon price, and it seems likely that more will follow.
 4. Finally, the global objective of reaching Net Zero will mean Carbon Dioxide Removal (CDR) must be done to offset any residual emissions. The cost of this, which is likely to be significant, will ultimately determine global carbon pricing.

Given the above it is likely to be beneficial for Hong Kong to join China's national emissions trading scheme when it has matured and been running smoothly for a few years. One option, therefore, is for Hong Kong, as the Chinese proverb says, to *'cross the river by feeling the stones'*. Specifically:

1. Put a price on the carbon content of fuels and energy sources as a revenue neutral switch. Specifically, the Government may consider by 1) reducing taxes on petrol and diesel, 2) RATES on property by about the amount of raised from collecting the carbon price. Further, to make this change in modest sized steps over, say, three years.
2. Join China's National Emissions Trading Scheme after it has been operative with little change for some years.

To summarise, the benefits of this approach are:

1. Aligning with China's Emissions Trading Scheme in the long-term thus facilitating economic links with the Mainland.
2. Reducing the risk of Hong Kong's exports being subject to CBAM charges by the European Unions and by other jurisdictions which may adopt CBAM type policies.
3. Broadening Hong Kong's tax base.
4. Minimise the risk that changes in China's National Carbon Trading Scheme as it is implemented disrupts Hong Kong's economy.

Strengthening implementation of Hong Kong's Climate Action Plan 2050 ('CAP2050')

This October 2021 plan contains welcome objectives with a list of measures which will help achieve these objectives. There is, however, a lack of clarity on the extent to which each measure will contribute to overall objectives and on the pathway to the 2035 targets. Further, there is very little reporting on progress towards meeting these objectives. Clearer reporting of progress against a published pathway will reduce the risk of failing to achieve the targets in the plan.

To comment on five areas in the plan:

1) Electricity and Gas supply

CAP2050 assumes a substantial increase in low-carbon electricity supply from the Mainland but is vague as to how this will be obtained. Since then:

- Energy shortages caused by conflict in Europe are expected to cause cost increases in Hong Kong in 2023.
- The Central Government has developed ambitious plans to expand low-carbon energy generation and put a price on carbon emissions with its National Carbon Trading Scheme.
- Cities in the Greater Bay Area (GBA) are implementing proactive low-carbon measures in accordance with China's 14th Five-Year Plan. We anticipate that low-carbon energy sources within the GBA area will be increasingly competitive compared to coal and gas.

We therefore recommend the government stabilise energy costs and accelerate Hong Kong's journey to Net Zero emissions by:

- Facilitating its utilities working with parties in the GBA to increase electricity generation from renewable sources and nuclear.
- Encourage the use of carbon capture and storage (CCS) to provide less carbon intense Towngas supply to Hong Kong and supplies for gas fired electricity generation plants needed to cover demand peaks.
- Conduct studies and enhance transparency in upgrading **cross-boundary energy wheeling infrastructure** and identifying investment needed.

2) Decarbonising building operations:

Hong Kong's buildings consume around 90% of its electricity with commercial buildings having particularly high consumption.

The Climate Action Plan 2050's target to reduce total electricity consumption in buildings³ by 2035 is a tough when one considers the increase in consumption since the 2015 and Lands Department's forecast for increases in the amount of built space in Hong Kong. We believe the following actions need to be taken to achieve the target:

1. Establishing a pathway of target reductions between current levels and the 2035 target and attributing reductions among the actions listed in the plan.
2. Developing fiscal measures which can be applied to incentivise reductions if Hong Kong looks likely to fail to achieve the target in the CAP2050. For example:

For large commercial buildings, we have recommended that Hong Kong follows other jurisdictions in creating an 'Energy Star' rating for building energy efficiency which is published on a government website. The 'Energy Star' rating gets public attention in the same way as hotel 'star ratings'. The system has many benefits including:

- (a) A comparison of actual and design energy performance to incentivise good design and commissioning.

³ The reference in the Climate Action Plan 2050 para 4.4.7 reads: *We have also set a medium-term target of reducing the electricity consumption of new and existing commercial buildings by 15% to 20%, and that of residential buildings by 10% to 15% by 2035, using the operational conditions of 2015 as the comparison basis.*

(b) The buildings performance is checked annually and its 'Energy Star' changed if performance has changed. This incentivizes attention to continuing to operate the building efficiently.

Once such a system is established, **fiscal measures** can be introduced to incentivise performance. Specifically, RATES on property can be adjusted so buildings with good energy efficiency are charged a lower percentage of rental value – say 3% - while those poor energy efficiency are charged a higher percentage of rental value – say 7%. Note:

1. Having this system provides a significant incentive to upgrade poor performing buildings. For the example numbers above they may be able to reduce the RATES by 4% of rental – ie. 7% less 3%.
2. The Government's total income from RATES can be kept constant by adjusting the midpoint for RATES.

3) Decarbonising building construction:

Constructing buildings leads to substantial carbon emissions - first in making materials such as steel and cement and then in the on-site construction. We recommend requiring building developers file a calculation of the embodied carbon with the Buildings Department within, say, six months of Occupation Permit. We further recommend that the Buildings Department makes this information available on its public website. Government might start this initiative for its own buildings and making it a requirement for being granted a Gross Floor Area concession. Benefits of this:

1. Making best practice visible leading to improvements in building design.
2. Providing a basis for the Government setting limits on the maximum carbon intensity of building construction.
3. At some point in the future reducing the cost of Carbon Dioxide Removal credits required to make construction materials 'Net Zero'.

4) Decarbonising mobility within Hong Kong:

Examples of fiscal policies which can aid decarbonising mobility in Hong Kong.

1. 'AVOID' some journeys by reducing barriers to people moving to live close to their place of employment. Specifically exempt Owner-Occupiers from paying Stamp Duty if they sell their home and buy another one to be closer to their work.
2. 'SHIFT' journeys to less carbon intense modes of transport by increasing the cost of using private cars. Over the past 20 years the number of private cars has increased by over 70% while there have been only modest increases in other vehicles. These cars take road space leading to traffic congestion which makes buses and freight move slower and burn more fuel per kilometre. One policy which would help is Electronic Road Pricing.
3. "IMPROVE" Develop an appropriate funding model to facilitate bus and other commercial fleet operators, upgrading their fleets to run on lower carbon or zero carbon fuels.

5) Reducing carbon emissions and other pollution from waste:

Hong Kong's recycling rate and capacity to recycle are low compared to leading cities in the region. The Government has taken some steps in recent years but much more is needed to be done to move Hong Kong closer to being a zero-waste city. We therefore support funding for:

- Feasibility studies for expanding **Hong Kong's recycling industries** in partnership with China's pioneering recycling industries.
- Searching for ways to **improve the export value for Hong Kong's recycling outputs**.

In addition, the extent to which people pay for the recycling of the waste they create needs to be gradually increased to a level which pays for the recycling costs.

Attachment 2: Managing the economic impact of physical risks from Climate Change

Climate Change will increase many physical risks including those from heat waves, sea level rise and more frequent severe weather bringing strong winds and heavy rain with the risk of flooding and landslips.

Further, the World Resources Institute estimates that 1 USD invested in adaptation generates between 2-10 USD in return in the form of damage avoided. For this reason, Hong Kong should continue to improve the readiness of infrastructure to withstand extreme weather events.

Hong Kong has already invested to strengthen its infrastructure to withstand extreme weather events currently forecast. We believe; however, more attention must be paid to longer-term risks.

Taking sea level rise as an example. Hong Kong, through the Hong Kong Observatory, has good processes for taking scientific advice for possible sea level risk up to 2100 and planning for it. However, for major investments such as the Northern Metropolis a longer time frame is appropriate. In its latest report the Intergovernmental Panel (IPCC) provides indications on sea level rises up to 2150 and 2300.

We recommend plans for Hong Kong's development include contingency plans for action should sea level rise to the levels which the IPCC's 'advises 'cannot be ruled out' under its 'Low Likelihood High Impact' scenarios. We suggest these contingency plans include:

- Explicitly noting the extent to which Hong Kong's existing 'progressive adaptive' strategies will cope with sea level rise. Under this strategy infrastructure is created to protect against the likely level of sea level rise while also making provision to add protection for a higher level of sea level rise should this occur.
- Establish a contingency plan to identify what can be done should sea level rise more than current plans can adapt to. This should include an assessment of developed areas which it will be uneconomic to defend and which must therefore be abandoned. This planning, may, for example lead to decisions in the next few years to service some areas by buses rather than making a more substantial investment in MTR lines.

We also recommend Hong Kong should increase funding to nature-based solutions. An example is mangroves protecting shorelines, sequestering carbon, and enhancing biodiversity.

Attachment 3: Hong Kong's Financial Services Sector participation in Just Energy Transition Partnerships.

Financial Services is one of the most economically important sectors of Hong Kong's economy. In 2020 it accounted for 23.4% of its GDP and provided some 276,200 jobsⁱ with the Hong Kong economy also benefiting from the expenditure of the people in employs. A significant part of its work is providing funding for Asia both directly and through Hong Kong companies investing regionally.

The Covid19 pandemic has weakened economies and caused travel restrictions which have impeded Hong Kong's ability to serve the region. As we emerge from the pandemic it is important to rebuild. Hong Kong should therefore seek a more prominent role in facilitating Just Energy Transition Partnerships (JETP)ⁱⁱ. This can both boost Hong Kong's Financial Services and aid regional decarbonisation. Details:

- A JETP is a financing mechanism which supports countries' self-defined pathways for moving from coal to low carbon electricity production. South Africa signed the first JETP of US\$8.5b in November 2021ⁱⁱⁱ and Indonesia^{iv} signed the second for US\$20.0b in November 2022. We believe there are discussions on JETPs for Vietnam and India with more to follow.
- We suggest HKMA leads Hong Kong financial services participation in JETPs by:
 - Issuing a 'JETP Bond' of, say, US\$2 billion. That is a 'Transition Bond' specifically for funding JETPs.
 - Seek 'most favoured nation treatment' for Hong Kong based banks to provide commercial funding to JETPs. Also, for Hong Kong's Financial Advisors, Lawyers and Accountants to provide services.

These two measures should increase the confidence and willingness of Hong Kong's financial services to participate.

- We believe the HKMA will need to set up units for activities which require Public Sector input. Specifically:
 - Setting up JETPs including defining the rules, identify potential transactions, promoting opportunities for Hong Kong Financial Services providers and providing governance for implementation.
 - Act as a project developer working with key project parties to renegotiate existing contracts and procure financing for the restructured early retirement of coal fire electricity generation. Then to be involved in operational-monitoring and troubleshooting.
- Advantages the HK Government / HKMA bring to this area:
 - Their involvement will make it easier for the Hong Kong Financial Services sector to participate in the deals.

- Their negotiating power as government agencies can reduce the risk of default and better manage recovery when there is a default. Further the HKMA should be able to borrow at a lower cost than its on-lending to the JETP thus providing a margin which covers both its administrative costs and taking some 'first loss' risk so projects with offtake contracts which are not quite commercially bankable can be efficiently brought into the scheme.
- They can fund necessary parts of JETPs which commercial banks may prefer not to cover. For example, funding buying existing coal fired plants so that they can be decommissioned in a prompt, orderly, Just-transition manner once lower carbon electricity is available.

END

References

- ⁱ HKTDC research on Hong Kong's economy: <https://research.hktdc.com/en/article/MzEzOTI4MDY3>
- ⁱⁱ Overview on Just Energy Transition Partnerships. November 2022 www.iisd.org/system/files/2022-11/just-energy-transition-partnerships.pdf
- ⁱⁱⁱ Progress report on South Africa's JETP www.gov.uk/government/publications/advancing-the-south-africa-just-energy-transition-partnership-12-month-progress-update/twelve-month-update-on-progress-in-advancing-the-south-africa-just-energy-transition-partnership#financing-package
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