

**Legislative Council Subcommittee on
West Kowloon Cultural District Development**

Financial Assessment of the West Kowloon Cultural District Project

Purpose

This paper provides further information on the financial assessment of the West Kowloon Cultural District (WKCD) project conducted by the Financial Advisor (FA) engaged by the Government. It also responds to the comments made by the Specialist Advisor engaged by the Subcommittee on the WKCD Development (the Subcommittee). For Members' easy reference, we have provided a short summary at **Annex 1**. Details are provided in the ensuing paragraphs.

The Financial Advisor

2. The Government engaged GHK (Hong Kong) Limited as its FA to assist in assessing the financial implications of the WKCD project in August 2006. The FA has conducted a detailed financial study on the project. The FA's final report was published in September 2007, as part of the large scale public engagement exercise on the recommendations of the Consultative Committee on the Core Arts and Cultural Facilities of the WKCD (Consultative Committee) conducted in September – December 2007. The FA has fielded a strong multi-disciplinary team to work on the consultancy including financial experts, public private partnership experts, performing arts venue and museum advisors and architects, engineering experts, quantity surveyors and land and property market specialists. Such wide range of expertise in particular the expertise in arts and culture are essential to the conduct of a proper and credible financial assessment of an integrated arts and cultural district.

Modus Operandi of the Financial Assessment

3. In estimating the costs and revenues of developing the arts and cultural facilities, the FA has made reference to relevant local facilities as well as comparable overseas facilities. The FA has worked closely with Home Affairs Bureau and relevant Government bureaux and departments in

coming up with very detailed assumptions underlying the estimation of the capital costs and operating revenue of the WKCD. The FA submitted its findings periodically to the Financial Matters Advisory Group (FMAG) set up under the Consultative Committee and attended FMAG meetings to seek FMAG members' views and advice on its findings.

Assumptions for Estimating the Capital Costs and Operating Cost and Revenue

4. It should be noted that in the FA's financial assessment, the Core Arts and Cultural Facilities (CACF) to be provided in the WKCD are those recommended by the other two advisory groups set up under the Consultative Committee, namely the Performing Arts and Tourism Group (PATAG) and Museums Advisory Group (MAG). Detailed assumptions were adopted by the FA for conducting the financial assessment. For instance, unit construction costs similar to comparable overseas facilities have been worked out as the basis for estimating the construction cost. The base construction costs are then adjusted with contract and project management on costs and risk premium reflecting the complexity and high quality standard required of the facilities, as well as an inflation rate reflecting the long term inflation trend. Appropriate operating assumptions have been worked out for each facility, including utilization rates, average ticket prices, attendance rates, venue programming costs, visitor numbers etc.

Response to the Report by the Specialist Advisor appointed by the Subcommittee

5. The Specialist Advisor engaged by the Subcommittee has made some comments on the report prepared by the FA and made some recommendations. Our response to these comments is set out below.

Funding proposal

6. Subcommittee's Specialist Advisor has not disputed the merits of providing a one-off upfront endowment for the WKCD project and requiring the West Kowloon Cultural District Authority (WKCDA) to operate the WKCD in a financially sustainable manner. The Specialist Advisor also noted that this would be most difficult to achieve under a subvention scheme. The Specialist Advisor has advised to put in place measures to ensure that the use of the upfront endowment is transparent and

accountable to the public at all times. We would like to point out that a number of transparency and accountability measures have been included under the WKCD Bill now being scrutinized by the WKCD Bills Committee. For instance, the WKCD is required to submit an annual report on its activities as well as an audited statement of accounts together with the auditor's report to the Financial Secretary who will cause it to be laid before the LegCo. The WKCD is also required to consult the public on matters relating to the development and operation of the arts and cultural facilities and other facilities. Additionally, the LegCo or any committee of the LegCo may request the WKCD Chairman and the Chief Executive Officer to attend its meetings and to answer questions raised by the Members of the LegCo at the meetings.

Financial Sustainability Beyond 50 Years

7. A 50-year project period was adopted by the FA as the duration for analyzing the financial viability of the long-term development of the WKCD. This is even more stringent than normal professional assessment of long-term projects. The FA's financial assessment indicates that the retail dining and entertainment facilities would generate an estimated income of \$8.4 billion (2008 NPV) over the first 50-year project period which is around 10% higher than the estimated total operating deficit of \$7.6 billion (2008 NPV) of the arts and cultural facilities and other related facilities. The overall financial assessment shows that the WKCD project should be financially sustainable on a long-term basis. Moreover, as the FA's financial assessment has made provision for major overhaul costs at appropriate intervals as well as annual building maintenance costs for each facility, this would effectively mean that all the facilities should be in good condition and fully functional even beyond 50 years. There is no question of having to seek another round of capital funding to re-build all the facilities after 50 years.

Cost and Revenue Estimation

8. The Financial Advisor's estimation of the construction costs was based on its professional knowledge and experience in these arts and cultural facilities and its knowledge of the local market, as well as the unit construction cost of comparable world-class arts and cultural facilities in the Mainland and overseas. The Architectural Services Department has advised that the FA's estimated unit construction costs are within a reasonable range.

9. The Specialist Advisor has also remarked that the FA's estimation of unit construction costs is reasonable. It has expressed its opinion on possible future escalation of construction cost. We consider that it is professionally sound and prudent for the FA to adopt an average inflation rate for long-term financial assessment, given the year-on-year volatility of construction costs in the local market, as evidenced by the historical ups and downs in cost escalations in the past twenty years which can fluctuate from -13% to +25% for individual years. We should also add that the FA has conducted a very sophisticated risk analysis of the construction of the arts and cultural facilities and has provided for considerable buffer to accommodate unexpected rises in construction cost.

10. Another point raised by the Specialist Advisor is about the rental income estimated to be generated from the retail, dining and entertainment facilities. In assessing the rentals from such facilities, the FA has already taken into account the location factor, the PATAG's preference for such facilities to integrate with the arts and cultural facilities and that they should not replicate large scale shopping malls. We should also take into account the likely increase in visitors in WKCD as a result of the provision of more facilities, improvement in transportation facilities and the impact of the Express Rail Link in the vicinity of WKCD. The FA's estimated rental income from the retail, dining and entertainment facilities is prudent and realistic.

Investment Return

11. We would like to point out that the estimated annual investment return of 6.1% over the project period falls comfortably within the range of the historical returns of overseas high quality bonds and growth rates of local and overseas equity indices. For instance, from 1996 to 2006, Moody's yield on seasoned all industries bonds ranged from 5.23% to 7.62% for Moody's AAA, 6.06% to 8.37% for Moody's BAA bonds. The compound annual growth rate for equities over the period January 1987 to January 2007 of the Hang Seng Index and the S&P 500 index were 10.9% and 8.6% respectively. Furthermore, the Exchange Fund generated a compound nominal annual investment return of 7% over the 14-year period from 1994 to 2007. To ensure that the investment of the upfront endowment would be managed properly, we are going to include in the WKCDA Bill the requirement for setting up an investment committee under the WKCD Board

to advise the WKCD Board on the investment of the upfront endowment as well as monitoring such investment. The investment committee should comprise individuals with relevant expertise and experiences.

Design and Build

12. Under the design and build approach, the client enters into contractual relationship with the contractor to design and construct the project in accordance with performance specifications prepared by the client. The contractor then enters into a series of separate agreements with consultants, specialist sub-contractors and suppliers to deliver the completed project in accordance with the agreed performance specifications. This method intends to encourage more contractor involvement, increase the speed of project delivery, lower the level of responsibility for the client, and increase the use of proprietary systems or modules.

13. The Specialist Advisor has commented on the approach of design and build. The Architectural Services Department who is experienced in executing design and build projects, has given a detailed response to the Specialist Advisor's comments, as set out in **Annex 2**. In brief, the design and build approach offers many advantages to the client over the approach of separating design contracts from building contracts.

Staffing Requirement of the WKCDA

14. The WKCDA will be responsible for the co-ordination of the planning, development and operation of the entire WKCD, including its arts and cultural facilities, communal facilities, transport facilities, commercial facilities, etc. In addition to the arts and cultural venues in WKCD, the whole WKCD site and other communal facilities in it like public open space and the automated people mover system will also be under the overall management of the WKCDA. The WKCDA has to prudently administer the financial resources involved. According to the FA's estimation, WKCDA will require 33 staff members to handle this area of work. This is a very streamlined structure having regard to the responsibility for the overall management of an integrated cultural district of 40 hectares.

15. During the initial development period of the WKCD (i.e. the first 7 years or so), WKCDA will require more staff to prepare a development plan for the whole WKCD site, organise design competitions,

monitor and execute the construction contracts of all the arts and cultural facilities and other facilities, as well as to conduct public consultations. The estimated staffing requirement of 90 people is considered to be not more than necessary. It has been drawn up with reference to comparable local and overseas organizations.

Economic Impact Assessment

16. The Specialist Advisor has made some comments on the Economic Impact Assessment Report prepared by the Government Economist. The Government Economist's response is set out in **Annex 3**.

M+

17. The Specialist Advisor suggested that should **M+** be run by an international operator, there will be substantial potential savings and **M+** might be operated with substantial surplus. As museums are cultural and educational institutions, they are typically loss making and their value should not be measured purely on financial returns. Development of museums is vision-driven and a long-term commitment in culture, arts and creative education. The **M+** has its mission to focus on 20th – 21st century “visual culture” (with design, moving image, popular culture and visual art (including ink art) as initial broad grouping). It seeks to present 20th – 21st century “visual culture” from a Hong Kong perspective, the perspective of now, and with a global vision. The model of engaging an international operator would be difficult to achieve this mission as the unique character and reputation of a world-class museum has to be built up overtime through accumulation of curatorial experience, persistent production of impressive programmes, collection and international networking and co-operations. All these would be difficult to obtain through franchise. Furthermore, curatorial freedom might be restricted under the international franchise model, and the costs involved might also be higher than expected.

18. The estimated capital costs and operating costs for **M+** were compiled with reference to comparable world-class museums. As **M+** is estimated to increase the total public museum space by around 50% in Hong Kong, the estimated annual operating deficit of around \$300 million (Phase I **M+**) as compared to the total recurrent expenditure of around \$500 million for all LCSD museums is prudent and reasonable. It should be noted that our financial assessment for **M+** has provided for about one-third of the

estimated annual operating costs (about \$100 million) for commissioning innovative and creative works from artists.

Public Sector Involvement

19. The three private sector involvement scenarios have been developed by the FA to compare the relative merits of involving the private sectors to differing degrees. These scenarios were used to test the financial implications of the project under these scenarios, taking into account the degree of risk transfer and financing costs to the private sector, as well as potential market interest in participating in the project.

Home Affairs Bureau
May 2008

<p>Summary of the Report submitted by the Specialist Advisor engaged by the Subcommittee on the West Kowloon Cultural District Development (the Subcommittee)</p>	<p>The Administration's Response</p>
<p>1. This report assumes the principle that the West Kowloon Cultural District (WKCD) should be self sufficient and financially sustainable. Capital and operating deficits would have to be met by land sales and operating income within the 40 hectares of land.</p>	<p>1. Only the land for residential, office and hotel uses within the 40-hectare site would be sold. The land would be sold by the Government separately. The land revenue would be paid into the general revenue and will not be used on the WKCD project.</p>
<p>2. The method of three comparing scenarios of private sector involvement is questionable. Scenarios 1B and 2 are not sufficiently realistic to be considered as practical options for meaningful comparisons. Moreover, despite greater private sector participation in these two scenarios, no additional efficiency gain has been allowed for.</p>	<p>2. The three Private Sector Involvement (PSI) scenarios demonstrate various levels of private sector involvement. In deciding which scenario is more appropriate, the following factors have to be taken into account, namely, the risk and financing costs, market response, the overall costs as well as operating revenue and expenditure. In the light of the operational risk of arts and cultural facilities, the existing PSI model has already balanced various considerations.</p>
<p>3. Design and Build contracts may not be a suitable procurement method for M+ and other core arts and cultural facilities.</p>	<p>3. The Government and local construction industry have many years of experience in executing design and build contracts. Being an effective model, it can bring about earlier delivery, and the contractor will bear the design and construction risks.</p>

<p>4. Arts and Cultural Facilities: unit construction costs range from \$22,200 to \$29,200 are on the high side. If it is of a high quality, it would be considered as falling within reasonable range. On-costs are, however, higher than conventional.</p>	<p>4. Agree. In estimating the on-costs, the Financial Advisor (FA) has taken into account the experience of technical consultants in various professional areas, made reference to charging standards of professional services issued by local professional bodies and the costs of some relevant facilities overseas.</p>
<p>5. The Financial Advisor (FA) sensitivity analyses have not tested the financial implications of risks in investment returns and in construction costs escalations. These tests should be carried out, and contingency plans should be formulated well in advance.</p>	<p>5. Construction costs and operation costs have included prudent risk premium to accommodate cost increase incurred by various risks. Investment return rate is similar to historical returns of high quality bonds overseas and is considered reasonable.</p>
<p>6. The FA analysis is confined to 50 years. There is no fund set aside for major renovations or re-constructions after 50 years, beyond which the WKCD may not be financially sustainable. An extra saving of \$3.38 billion on capital and operating costs, equivalent to 16% of the \$21.6 billion seed fund, is needed.</p>	<p>6.</p> <ul style="list-style-type: none"> • The use of 50-year project period is even more stringent than the professional assessment of other long-term projects. • We estimate that the retail, dining and entertainment facilities would generate an estimated rental income of \$8.4 billion (2008 Net Present Value) over the first 50-year project period which is around 10% higher than the estimated total operating deficit of \$7.6 billion (2008 Net Present Value) of the arts and cultural facilities. Arts and cultural facilities could be operated in a financially sustainable manner.

	<ul style="list-style-type: none"> • Provision has already been made for regular major overhaul as well as annual building maintenance during the 50-year project period. All facilities will be in good condition and fully functional beyond 50 years. No question of demolishing or re-building the facilities immediately after 50 years.
<p>7. Under the FA operating assumptions, M+ would cost \$10.7 billion to construct and operate for 50 years. By 2059, M+ would contribute 89% of the WKCD yearly deficit. M+ might become a long-term financial burden of the WKCD.</p>	<p>7. • The estimated construction cost of M+ is \$2.6 billion.</p> <ul style="list-style-type: none"> • The estimated annual operating deficit of M+ is around \$300 million, which is comparable to the total recurrent expenditure of around \$500 million for all Leisure and Cultural Services Department museums. • The rental income from retail, dining and entertainment (RDE) facilities can fully cover the overall total operating deficit of the arts and cultural facilities (including M+).
<p>8. According to the information provided by the FA so far, should M+ be run by an international operator, the potential saving, in very crude terms, could be as high as \$4.8 billion (i.e. 22% of the \$21.6 billion seed fund). There is a big difference prima facie and should be studied carefully.</p>	<p>8. Engaging an international operator to operate M+ will not achieve M+'s vision and M+ would lose Hong Kong's unique cultural character and curatorial freedom. It will also restrict M+'s future development and hinder its co-operation with internationally renowned museums on a mutually beneficial basis. This development model may also incur higher costs than expected.</p>

<p>9. Annual deficits of the WKCD would have to be met by RDE rentals. RDE is therefore the life line of the WKCD. Yet compared to the detailed operating assumptions provided for Core Arts and Cultural Facilities (CACF), down to the smallest of theatres, those provided for RDE are clearly insufficient.</p>	<p>9. The estimated rental income level for retail/dining/entertainment facilities is considerably conservative, because it has taken into account the need for these facilities to integrate with the arts and cultural facilities and that they are not comparable to the operation of large scale shopping malls. The estimated rental has not taken into account the positive impact on rental of commercial facilities due to the increase in people flow arising from connecting WKCD with the Express Rail Link.</p>
<p>10. In considering the funding priority for each individual facility/cost item, factors including uncertainty in financial performance, potential benefits on further investigation and its financial significance, should all be taken into account. To build up the financial strength of the WKCD, considerations in (a) reduction of on-costs; (b) a more efficient operation mode of M+; and (c) an effective business plan for RDE facilities are essential.</p>	<p>10. While we have no objection to point (a), points (b) and (c) should be duly considered by the future WKCD Authority. However, WKCD Authority at the same time has to take into account the need for integrated development and the need to be conducive to the objectives of WKCD in promoting arts and cultural development.</p>
<p>Note 1</p> <p>The core team formed by the Legislative Council's Specialist Advisor comprises the following professors and researchers:</p> <ul style="list-style-type: none"> • Associate Professor at the Department of Real Estate and Construction, The University of Hong Kong (HKU) 	<p>The multi-disciplinary professional team formed by the Government's FA comprises:</p> <ul style="list-style-type: none"> • financial experts • public private partnership experts • performing arts venue and museum

<ul style="list-style-type: none"> • Chair Professor of Real Estate and Construction, HKU • Assistant Professor of the Department of Real Estate and Construction, HKU • Post-Doctorate Fellow of the Department of Real Estate and Construction, HKU • Associate Dean of Faculty of Business and Economics and Associate Professor of Finance, HKU 	<p>advisors</p> <ul style="list-style-type: none"> • architects • engineering experts • quantity surveyors • land and property market specialists
<p>Note 2</p> <ul style="list-style-type: none"> • The report took more than one month to complete. 	<p>The report took more than one year to complete.</p>

Design and Build Vs Designer Led Contracts – Architectural Services Department’s Response to Versitech’s Comparison between the "Design and Build" and "Conventional" modes of procurement as outlined in Section 6.2 of their Final Report dated 21 May 2008 (Note – Versitech’s Final Report is available in English only.)

Design and Build	Conventional Design then Build (Designer Led)
<p>Require well-prepared Employer’s Requirement (ER) beforehand.</p> <p><u>Architectural Services Department (ArchSD)’s Comments</u> Yes</p>	<p>Invite tender after completing detail design.</p> <p><u>Architectural Services Department (ArchSD)’s Comments</u> Yes</p>
<p>Difficult to prepare a complete set of Employer’s Requirement.</p> <p><u>ArchSD’s Comments</u> The Government and the local construction industry have over 17 years of experience in preparing ERs for D&B contracts.</p>	<p>Invite tender only after satisfied with the quality and standard of space, level of comfort, aesthetic requirements and architectural details.</p> <p><u>ArchSD’s Comments</u> Construction cannot commence until the whole project is designed and extra time is required for the sequential activities. No input by the contractor on buildability at early stage and any problem faced later will have to be paid by the client.</p>
<p>How to specify the quality and standard of space, level of comfort, aesthetic requirements and architectural details?</p> <p><u>ArchSD’s Comments</u> Performance-based specifications are prepared which provide focus on outcomes rather than process.</p>	

Design and Build	Conventional Design then Build (Designer Led)
<p>The objective is to develop a specification that allows bidders to bring their individual expertise, creativity, and resources to the bid process without encumbering them with predetermined methods or details.</p> <p>Writing specifications from this point of view increases alternatives, attracting more design innovations and fostering better competitions.</p> <p>D&B procurement is in fact one form of design competition yet the procurement method is better than standalone design competition since buildability for a D&B proposal is guaranteed. For design competition alone, the project progress may end up not as smooth as anticipated. For D&B procurement, stakeholders in the industry form their own multi-disciplinary team to provide a buildable solution and compete for an integrated design in the one-stage design competition. Architectural, building services, structural and financial merits are being considered during the selection process, achieving value for money and good costs control for Design and Build contracts.</p>	
<p>Contractor may cut corners to save costs to meet minimum standards required.</p> <p><u>ArchSD's Comments</u></p> <p>The ER must be verifiable or measurable and the Supervising Officer (SO) of the D&B contract must be able to determine whether the D&B Contractor will perform as required.</p> <p>The D&B Contractor is required to seek the SO's approvals on all design elements before he could proceed to the next work stage. The SO will have full control to ensure the required standards are met.</p>	<p>With all construction details, tender costs more accurate.</p> <p>The design forms the Contractor tender</p> <p><u>ArchSD's Comments</u></p> <p>Tender costs are based on the design and the Contractor is more certain about costs since he is only responsible for constructing according to the design. In this case, the client bears the risks on buildability.</p>
<p>Lack independent views from the architect</p> <p><u>ArchSD's Comments</u></p> <p>The D&B procurement method was intended to encourage more</p>	<p>Have independent views from the architect.</p>

Design and Build	Conventional Design then Build (Designer Led)
<p>contractor involvement, increase the speed of delivery, lower the level of responsibility of the client and increase the use of proprietary systems or modules.</p> <p>Since the D&B team (contractor and designers) is competing for an integrated design in the one-stage design competition, the contractor must obtain views from all design partners, including the architect, in order to formulate a balanced view.</p>	
<p>Maybe faster and costs less.</p> <p><u>ArchSD's Comments</u></p> <p>Bennett, Potheary and Robinson state: D & B contracting:</p> <ul style="list-style-type: none"> - Is 12% faster than the sequential contracting method and takes 30% less time to deliver a project from the start of design to completion of the works - Is 13% cheaper than sequential methods and - Projects are 50% more likely to finish on time. 	<p>Requires better project management professionals.</p>
<p>Contractor will make claims for scope of works not described in the Employer's Requirement. The sum claimed is more substantial.</p> <p><u>ArchSD's Comments</u></p> <p>It is just fair to pay extra for works not included in the original contract scope, both for D&B or Designer-led contracts.</p> <p>For Designer-led contract, we pay the extra sums separately to the designer and the contractor, whereas for D&B contract we pay an integrated sum to the D&B contractor.</p> <p>There is no evidence to prove that the sum claimed for variation work is usually more substantial for D&B contracts. On the contrary, as long as</p>	<p>May need more time for finalizing the construction details but could achieve better value for money.</p> <p><u>ArchSD's Comments</u></p> <p>Much depends on quality of the design and specifications issued with the tender.</p>

Design and Build	Conventional Design then Build (Designer Led)
<p>no abortive work is involved and the bulk of work remains the same, a D&B contract allows for change of requirements during the design development stage without substantial cost implications.</p> <p>In fact since the contractor becomes solely responsible for all aspects of the project delivery process, most of the risk associated with design and construction are borne by the contractor, therefore giving the client greater protection.</p>	
<p>Suitable for simple, easy-to-specify, easy-to-illustrate projects, such as civil engineering works, simple office buildings.</p> <p><u>ArchSD's Comments</u></p> <p>The Government and the construction industry have accumulated adequate experience in D&B procurement and have successfully awarded and/or delivered a number of projects with highly complex requirements. Examples are the Tamar Development, the ICAC Headquarters, the Customs Headquarters, the Prince of Wales Hospital Extension, the Lo Wu Prison, etc.</p>	<p>More suitable for artistic, creative, complicated buildings such as the M+ and facilities for performing arts.</p>
<p>For both contracts, critical to first appoint the operator before starting the design.</p> <p><u>ArchSD's Comments</u></p> <p>The operator may change after a period of time. Provided the ER could be formulated, the client may decide to work with the D&B contractor direct, or requires the D&B contractor to work with the potential operator as necessary.</p>	

**Final Report of the Specialist Advisor Versitech Ltd.
to the Subcommittee on West Kowloon Cultural District (WKCD) Development
for the Study on the Financial Aspects of the WKCD Project
for the Legislative Council Commission –
Responses from the Government Economist**

The Final Report provided by Versitech Ltd. (“the Report”) made various comments on the Economic Impact Assessment (“EIA”) prepared by the Economic Analysis and Business Facilitation Unit (Section 9 as well as various other paragraphs of the Final Report). Responses from the Government Economist are set out below:

Methodology of estimation (cf. section 9.1, p.41 of the Final Report)

2. The Specialist Advisor suggested that the EIA “must also examine the benefits derived from the alternative uses of the land (i.e. opportunity cost) at the WKCD”. We wish to clarify that the EIA is intended to evaluate the intangible and tangible economic impact brought about by the project on the economy as a whole, which is different from an economic cost-benefit analysis of WKCD as a standalone project. As shown in our EIA report, the development of the West Kowloon Cultural District (WKCD) is expected to bring about not only significant tangible economic impacts to Hong Kong, in terms of value added contributions and employment creation, but also intangible economic impact, as the project serves as an important strategic investment in Hong Kong’s arts and cultural infrastructure that would promote arts and cultural activities and enhance Hong Kong’s status as an international city.

3. From a planning and development perspective, the Government takes into account a wide range of factors, including social aspirations of the community, the holistic developmental needs of Hong Kong, and the spatial distribution of various public facilities such as police stations, schools, parks, etc. As reflected in the public engagement exercise for the WKCD project, the Government received an overwhelming support for the overall vision and strong support for early implementation of the WKCD. Against this backdrop of clear community’s aspiration, it is not meaningful to undertake an assessment of an alternative land use option for the WKCD site. Indeed, it would be wrong to evaluate the cost-benefit of WKCD, (or for that matter other public facilities such as a sports complex or a

university), by evaluating the value of alternative uses of the site.

4. Besides, the Specialist Advisor cast doubt about the scientific basis of the estimated attendance used in both the Financial Advisor (FA)'s assessment and the EIA. As we have explained to the Specialist Advisor, the total attendance deployed in the FA's assessment was compiled on a set of planning parameters, taking into account the objective of developing world-class arts and cultural facilities in the WKCD, local attendance experiences of various facilities in the past from LCSD, and the experiences of various international renowned facilities. All parameters adopted in the assessments are objective and prudent, and went through careful deliberations. In any case, projections about future attendance are NOT an important element in determining the financial viability of WKCD as a whole. Actual attendance in the future will also depend very much on how the future WKCD facilities are managed.

Interpretation of the impact (cf. section 9.2, p.41-42 of the Final Report)

5. The Specialist Advisor opined that "a unique feature that differentiates a 'world-class cultural and arts district' from a pure property development is its benefits to tourism". We have reservations about this opinion. The scope of developing WKCD is far wider than a pure tourism project, as highlighted in the various tangible and intangible benefits mentioned in the EIA report.

Performance indicators (cf. section 9.3, p.42 of the Final Report)

6. As explained above, the EIA intends to assess the potential macroeconomic impact of the project on the economy as a whole. It is not a suitable process used to identify and devise performance indicators on the operational front. The mode of operation of the proposed WKCD Authority will by and large hinge on the respective legislation which governs the overall institutional design of the Authority. The future Management of WKCD should also be given the responsibility to agree with the relevant authorities what performance indicators should be used.

The 2% inflation assumption over a 50-year time horizon (cf. pp.15-17, 19 and 35 of the Final Report)

7. The Specialist Advisor questioned in various parts of the Final Report whether the 2% long-term inflation rate assumption is realistic. It should be noted that inflation assumptions for a 50-year period are subject to much uncertainty. As

an advance economy and under a currency board system with the Hong Kong dollar linked to the US dollar, Hong Kong's inflation over the longer run would be more or less in line with those experienced by economies at a similar stage of development. The implicit or explicit inflation targets set by most major central banks in the advance economies are around 2%. Thus, a long-term inflation rate assumption of 2% is considered acceptable.

8. In any case, the results of the financial analysis done by the financial consultants are not sensitive to inflation assumptions, as both revenues and costs would broadly increase along with the general inflation rate over time. Indeed, the Specialist Advisor also realizes this point, as given in the third paragraph on p.17 of the Final Report, "... instead of inflating prices at 2% per annum, and subsequently discounting them ..., it would be much simpler to use the real rate of interest of 4% per annum to discount future prices".

Economic Analysis and Business Facilitation Unit
Financial Secretary's Office
28 May 2008