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27 February 2004

Messrs Cheung, Chan & Chung
Unit 5505, 55/F Hopewell Centre
183 Queen's Road East
Wanchai
Hong Kong

By Post & By Fax (2845 3467)

Dear Sirs,

**Lease Modification -
Kowloon Inland Lot No. 11076**

Thank you for your letter dated 25 February 2004.

As requested I attach draft of the Paper to LegCo. I would be grateful for your client's consent to disclosure to LegCo in terms of the draft.

The Paper was intended to be delivered to LegCo before now. Anyway, the deadline for delivery is tomorrow, Saturday, 28 February 2004. Therefore, your client's consent by return would be greatly appreciated.

If necessary, please speak with the undersigned or, in his absence, with John Corrigan (tel. no. 2231 3088).

Yours faithfully,

(A.L. Robertson)
Assistant Director/Legal
for Director of Lands

c.c. D of H (Attn : Mr Vincent Tong)
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Hunghom Peninsula
Private Sector Participation Scheme Flats
Lease Modification Premium

Purpose

At the joint meeting of the Legislative Council Panel on Housing and Panel on Planning, Lands and Works on 17 February 2004, Members requested the Administration to provide details in writing of the basis for accepting the agreed premium of \$864 million for lease modification of Lot 11076 to allow the developer for the Hunghom Peninsula Private Sector Participation Scheme (PSPS) project to dispose of the flats in the open market. The mediation and subsequent settlement agreement between Government and the developer are subject to usual non-disclosure conditions. In order to enable Members to gain a better understanding of the matter, we have secured the developer's consent to our disclosure to Members of the Legislative Council of pertinent information about the mediation. This paper serves to explain the basis for settling this lease modification at a premium of \$864 million.

Preamble

2. The Secretary for Housing, Planning and Lands outlined the main policy considerations in deciding how to dispose of the PSPS flats at Hunghom Peninsula at the meeting on 17 February 2004. The decision to negotiate with the developer on a lease modification to allow him to dispose of his flats in the open market should not be viewed in isolation, but should be considered as part and parcel of the re-positioned housing policy announced in November 2002 amidst the then unstable property market which was hard hit by the serious imbalance between flat demand and supply and the negative equity problem. There was a widespread demand that the Government should withdraw from its role as property developer and minimize its intervention into the market. It was against such background that the Government came to the view that we should negotiate with the developer on lease modification discharging the Housing Authority (HA)'s obligations in nominating purchasers to buy the PSPS flats and allowing the developer to sell his flats in the open market. The reasoning for these decisions is given in the following paragraphs.

Overriding Policy Considerations

3. In November 2002, the Government announced its statement on housing policy to make clear its determination to fully withdraw from the market and cease the sale of subsidized sale flats. We re-positioned our housing policy, and introduced a series of initiatives to stabilise the property market. In particular, we stated clearly that in line with the new policy, the Government would terminate the Home Ownership Scheme (HOS) and PSPS. At that time, we were well aware of the need to dispose of the large number of surplus HOS flats and the PSPS flats, and we had announced our plan to identify means of disposal that would not have an adverse impact on the then ailing property market. In the case of the flats of the Hunghom Peninsula and Kingsford Terrace PSPS projects, Government and the HA explored the feasibility of different options to dispose of the PSPS flats.

4. It should be pointed out that the Land Grant provisions of Hunghom Peninsula and Kingsford Terrace PSPS projects were different from those of the HOS developments. The developer holds legal title to the land lot, owns the residential units, the car parking spaces and commercial facilities it built as required by the Conditions of Sale. Under the Conditions of Sale, there are provisions according to which the HA would nominate eligible purchasers to purchase the flats from the developer within 20 months of the date of the issue of a Consent to Sell. In the event that flats are unsold at the end of the 20-month period, the HA is facing an obligation to purchase the flats at the guaranteed purchase price upon a valid notice from the developer.

5. The Government has thoroughly examined the feasibility of a whole range of different options in the disposal of the Hunghom Peninsula PSPS flats, including, amongst others, the option of purchasing the flats for sale through open tender in the market. The Government considers that the latter disposal method would have a devastating effect on the credibility of the recently pronounced policy of not intervening or participating in the property market, which, we have repeatedly emphasized, will remain clear, certain and consistent. Apart from the adverse impact the latter disposal method would have on our policy of not intervening or participating in the property market, we were also wary of any legal challenge that the developer might bring against Government and the HA regarding the rights and obligations of Government and HA in terms of the lease. We were careful not to commit any action that might constitute a breach of the lease conditions. Having considered the importance of implementing and avoiding acting contrary to the repositioned housing policy, and in view of the contractual and other constraints arising from the lease restrictions regarding the disposal of the PSPS flats, the

Government concluded that the only viable and practicable way of approaching the issue was to initiate negotiation with the developer to allow it to sell the flats in the market subject to the payment of a lease modification premium. This conclusion was reached in circumstances where Government was fully aware that the agreement of the developer was essential to resolving the problem and the circumstances dictated that it was for Government and HA to take the initiative in instigating negotiations to obtain the developer's agreement.

6. In fact, we informed the Housing Panel of the Legislative Council about this approach of initiating negotiations to allow the developer to sell the flats into the open market on three occasions i.e. in January, March and November 2003. Besides, a Legislative Council written question was asked on the matter in October 2003. In reply, we informed the Council that the developer of Hung Hom Peninsula had filed a writ against the Government and the HA and that the Government had commenced negotiations with the developer concerned with a view to modifying the lease to enable the latter to dispose of the flats.

Reasons for Mediation

7. Government commenced negotiations with the developer in early January 2003 on the basis of premium equating to the increase in value conferred. The initial negotiation was however fruitless because there was a huge gap between Government's position and that of the developer. Apart from the difference between the two sides on the value of the PSPS flats in the open market, another major difference in position was on whether or not the developer's claim that it had to meet extra costs and suffered losses as a result of the alleged failure of the HA to nominate PSPS purchasers was substantiated. Negotiations had basically come to a standstill.

8. With the passage of time, the deadline for the HA to nominate purchasers or, alternatively to face having to purchase all the flats in July 2004 had become more and more critical. In July 2003, the developer initiated legal action against the HA and the Government, alleging breaches of terms of Land Grant and claiming damages. Legal advice is that if the developer's claim succeeded, the HA could be exposed to substantial damages as awarded by the Court on top of the guaranteed purchase price. The Government re-visited all options and considered how to respond to the situation. After taking into consideration a host of factors including the risks and costs of litigation and that negotiations with the developer in early 2003 had concluded in an impasse, the Government had decided to try to resolve the

matter through mediation on the following grounds –

- (a) the settlement of disputes by means of mediation is commonly employed in the commercial sector when there is an unbridgeable gap in the position of the two sides;
- (b) an advantage of mediation is that it would be considerably less expensive than protracted High Court proceedings;
- (c) mediation is generally accepted to be a process that facilitate resolution of disputes and is time and cost effective as compared with litigation; and
- (d) resolution of the litigation alone would not resolve the problem of disposal of the flats.

The Mediation

9. The mediation was conducted and concluded between 8 December and 23 December 2003 before an independent mediator, who is accredited by the Hong Kong International Arbitration Centre. A full 4 days was spent in the mediation on negotiations on premium. It became very clear that the developer was not prepared to offer more than \$864 million. The developer maintained that the \$864 million had a valuation basis. Government could not and did not agree that the \$864 million had such a basis.

Basis for Settlement

10. We have carefully assessed the pros and cons of accepting \$864 million as the agreed settlement sum. It was noted that contrary to the norm in lease modifications, the initiative for this lease modification was Government's which itself is very unusual but in a situation quite different from the norm: in the usual situation if a modification premium is not agreed, the potential for obtaining a premium in future remains. This is not so with Hunghom Peninsula. Further, while the developer will be able to sell the flats on the market, the developer like any other developers has also to take on the challenging market conditions as existed then and might prevail thereafter. Agreeing the lease modification at \$864 million has the following advantages –

- (a) it avoids the HA having to purchase the 2,470 flats in the development

at about \$1,914 million;

- (b) it immediately sets a limit on the period for which the developer can claim to have suffered losses due to the alleged failure of the HA to nominate purchasers, assuming that the HA is liable; and
- (c) the Government collects a premium of \$864 million.

11. Otherwise, the HA would have to pay \$1,914 million and acquire 2,470 flats which could not be disposed of in a rational manner given the above overriding policy considerations. No premium would be received and in effect the Government would be forgoing the \$864 million offered by the developer. The Government and the HA would suffer a "loss" of a total \$2,778 million (paying \$1,914 million and not receiving the \$864 million premium) which would be avoided by the modification going ahead. Any damages successfully claimed would continue to accrue without the "time limit" that the modification would have provided.

12. After balancing the above, the Government considered that settling the lease modification at a premium of \$864 million was a good deal in all the circumstances. Government remains firmly of that view.

13. The litigation involving the developer's claim for damages arising from the alleged delay in the nomination of purchasers by the HA is at an earlier stage. The issue of liability has not been determined let alone the amount of damages that the developer would be entitled to in the event of it establishing breach. However, all parties concerned have left the door open for further negotiation on these claims and will continue to attempt to reach an agreement. Otherwise, these claims will have to be resolved by the Court.

14. Members have requested details of discussions on the premium during the mediation. These details are at Annex A.

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Annex A

The mediation was conducted and concluded between 8 December and 23 December 2003 before an independent mediator who is accredited by the Hong Kong International Arbitration Centre. During the course of mediation, both parties carefully examined each other's figures in the presence of the mediator. There were differences on the estimated sale price of the flats after upgrading works, developer's profit/bulk discount, marketing cost, upgrading cost and period for sale of flats after completion of upgrading works. Our position was vigorously challenged by the developer. In particular, the developer argued that a greater profit/bulk discount was appropriate to reflect the substantial number of flats, and the developer adopted a much lower estimated sale price of the flats.

After several rounds of exchange of details, we proposed, as a basis for settlement and bearing in mind the inherent difficulties in valuing 2,470 upgraded PSPS flats as one lot, a premium of \$1,310 million based on an estimated sale price of \$38,000/m² net (\$3,021/sq.ft gross) for the flats and a 15% bulk discount/profit. The developer rejected our proposal and counter-offered a modification premium of \$864 million, which we understood; was based on, among other things, a selling price of \$35,050/m² net (\$2,800/sq.ft gross) and a profit margin of 20%. Despite further intensive discussions between the two sides, the developer declined to move from this position.