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Panel on Economic Development Meeting on 25 January 2010

Updated background brief on Hong Kong Disneyland

Purpose

This paper provides background information on the Hong Kong Disneyland (HKD) project, its operation since opening in 2005 and the expansion plan. It also summarizes major concerns and views of Members on related issues.

Background

2. In December 1999, the Government entered into an agreement with The Walt Disney Company (TWDC) to build HKD (Phase 1) at Penny's Bay¹. A joint venture company, the Hongkong International Theme Parks Limited (HKITP), was set up for this purpose². The then estimated total project cost of developing HKD Phase 1 was \$14.1 billion, in addition to an estimate of \$4 billion for the cost of reclaiming the land for Phase 1 of the project. The Government and TWDC had entered into five main agreements covering management, licensing of intellectual property, rights and obligations of shareholders, loan arrangements as well as the parties' responsibilities and undertakings for the development of HKD. Related financial and staffing proposals were considered by the Panel on Economic Services³ (the Panel) at the meetings on 11 and 15 November 1999, and approved by the Public Works Subcommittee and the Finance Committee (FC) at the meetings on 17 and 26 November 1999 respectively.

3. According to the Administration's assessment made in 1999, HKD would generate huge economic benefits for the Hong Kong economy, estimated to reach

¹ The agreement anticipates a Phase 2 project, which will include a second Disney theme park, additional hotels and an expansion of the retail, dining and entertainment complex. Accordingly, HKITP is given an Option to buy the site immediately to the east of the Phase 1 Site for development of the second phase.

² Under the agreement, the Government owns 57% of the shares in HKITP while TWDC owns 43%. HKITP operates under the supervision of a Board of Directors, which comprises five Government directors, four Disney directors and two independent non-executive directors.

³ The Panel on Economic Services has been renamed as the Panel on Economic Development with effect from the 2007-2008 session.

\$148 billion over 40 years⁴. Opened on 12 September 2005, HKD received in total 5.2 million visitors during the first year of operation⁵, while the second-year attendance was lower than expected, registering only some 4 million. As at end May 2009, HKD has received a total of over 17 million visitors. The two hotels at HKD recorded a combined occupancy rate close to 80% in 2007-2008, representing an 8% point growth from 2006-2007. As in November 2009, HKD employs more than 5 000 Cast Members.

4. To improve the financial position of HKITP, TWDC has waived the management fees and deferred payment of royalties for two years (i.e. 2007-2008 and 2008-2009). As at the end of 2007, HKD has also negotiated with commercial lenders to re-schedule its commercial term loan facility and the revolving credit facility with a view to reducing interest expenses. In September 2008, an agreement was reached between the Government and TWDC, under which the latter loaned \$3.26 billion (consisting of a term loan and revolving credit facility) to HKITP. The loan was used mainly to repay the company's commercial loan.

Expansion Plan

Financing arrangements

5. To realize the benefits of the long-term investment in HKD, the Government and TWDC commenced discussion in December 2007 on an expansion plan⁶ for HKD, which TWDC estimated to cost \$3.63 billion. The expansion proposal comprised three new themed areas, with more than 30 new attractions, bringing the total number of attractions in HKD to over 100. To protect the interests of HKD, the Government has sought and secured TWDC's assurance that two of the new themed areas, i.e. "Grizzly Trail" and "Mystic Point", will be exclusive amongst Disney theme parks worldwide and the remaining one, i.e. "Toy Story Land", will be exclusive amongst Disney theme parks within the Asian region at the time of their respective opening⁷. The new attractions are expected to be completed in phases over five years by 2014.

6. After careful consideration of various financial options, the Government

⁴ The economic benefits of \$148 billion over 40 years were calculated on the "base case" scenario developed in 1999. Under the "base case" scenario, it was estimated that HKD would attract an attendance of 5.2 million in its first year of operation and such attendance would rise steadily thereafter to 5.47 million in 2006 and 10.57 million in 2044. At the meeting of the Panel on Economic Services on 29 July 2002, members were informed that TWDC considered the base case forecast conducted in 1999 too conservative and had therefore revised the attendance figure for the first year upward to 5.6 million.

⁵ Each year of operation of HKD starts in October and ends in the next September.

⁶ Phase 1 Site covers about 126-hectare of land of which some 80 hectares have been developed. The expansion plan is related to the development of the remaining 40 hectares.

⁷ The combination of key storylines and technological elements of these themed areas will not be substantially repeated in any other Disney theme park within five years from their opening.

has reached agreement in principle with TWDC to a package deal in June 2009. TWDC will contribute all the necessary new capital as equity for the construction of the new attractions as well as sustaining the park's operation during the construction years, and convert the entire outstanding balance of the TWDC loan (i.e. 2.76 billion) to equity. Although the Government will not inject any new capital for the expansion, it will convert its loan to equity but retaining a balance of not less than \$1 billion. Upon the capital injection by TWDC and conversion of the Government and TWDC loans, the Government will continue to be a majority shareholder of HKITP with ownership of about 52%⁸. The financial arrangements relating to the expansion of HKD were approved by FC at the meeting on 10 July 2009.

7. To encourage the park management to deliver results, the Government has obtained TWDC's agreement to revise the formula for calculating the base management fee⁹ to link it to HKITP's performance, i.e. to replace the current formula of 2% of gross revenue by 6.5% of earnings before interest, tax, depreciation and amortization (EBITDA). A mechanism will also be put in place such that payment of royalties to TWDC's related company/licensor by HKITP will be deferred in the event that HKD's financial performance is hampered by adversity.

Enhanced transparency

8. To enhance the transparency of HKD's operation, TWDC has agreed to make annual disclosure of the main operating and financial results of HKD starting from 2008-2009, which will include business indicators and aggregate financial indicators for both the current and the immediately prior financial year. The list of indicators to be disclosed is in the **Appendix**.

Concerns expressed by Members in previous discussions

9. Since the opening of HKD in September 2005, Members have raised a number of questions at Council meetings on issues related to the operation and performance of the park, public transport services for visitors, employment matters, financial and governance arrangements as well as injection of funds into HKD. Members of the Panel have also deliberated on related issues from 2005 to 2008 when the Administration reported on the progress update on HKD for each operation year. A series of Panel meetings has been held to examine the HKD expansion project before the proposal was considered by FC in July 2009. The views and concerns expressed by Members at the meetings of the Council, FC and the Panel are summarized in the ensuing paragraphs.

⁸ The Government's shares in HKITP will be lowered from 57% to 52% under the expansion plan.

⁹ The agreement reached between Government and TWDC in 1999 also provided for a variable management fee with the rate of 2-8% of EBITDA. Under the new arrangement, the rate will be revised to 0-8% of EBITDA.

Park attendance and marketing strategy

10. Some Panel members expressed concern that the patronage to the park had fallen short of the base case scenario projected in 1999, and urged the park management to step up its promotional and marketing efforts to boost attendance. In particular, members highlighted the need to draw up a comprehensive business plan to tie in with the expansion project. It was suggested that HKD should incorporate more local cultural elements to suit the taste of the local public, and conduct more programmes in Putonghua to cater for the needs of Mainland visitors. A member suggested that the Government should review its policy measures to enable transit passengers to visit HKD before returning to the Mainland. HKD was also urged to consider partnering with the Ocean Park, Asia World Expo and other scenic spots in offering city pass for visitors, and collaborate with the travel trade in the Mainland and other source markets in Asia in promoting the park and the two hotels to tourists visiting Hong Kong.

11. To attract more visitors to HKD, some Members considered it important to also enhance the accessibility of the theme park through the provision of different transport infrastructures, such as making better use of the pier near HKD. The Government was also urged to put the land adjacent to HKD to more gainful use, with a view to enhancing synergies with HKD and boosting patronage to the park. In face of competition from local and regional theme parks including Ocean Park, the prospective Disneyland in Shanghai and the Universal Studio in Singapore, members were concerned about the business viability of HKD, and stressed the importance to improve the park's operation and management to withstand the fierce competition.

Park management and transparency of operation

12. A Member raised a LegCo question concerning whether there was conflict in the Government's roles as the rule-setting authority for the market on the one hand, and as a market participant for being the majoring shareholder of HKITP on the other. There were also concerns how the Government directors in the Board of HKITP could monitor the operation of the park effectively, in particular the expenditure on HKD's expansion. Some Members suggested appointing a greater number of independent directors from the business and financial fields as well as the travel trade to the Board to oversee HKITP's operation.

13. Some Members repeatedly urged the Government to enhance the transparency of HKD's operation by disclosing the financial performance of HKITP, including park attendance, payment of management fees and royalties, and TWDC's business transactions with related parties. Some Members opined that the Government should not be bound by the confidentiality provision in the existing agreement not to disclose the relevant information. They took the view that the Government should take the opportunity of negotiation for the expansion plan and urge TWDC to disclose the information for the previous years.

14. As for the calculation of base management fee, some Members considered it difficult to assess the new formula in absence of information on the financial

performance of HKITP in previous years. To safeguard the interests of HKD, it was suggested that the Government should consider calculating the base management fee on the basis of whichever of the old and the new formulae was lower, and a park attendance threshold should be set as a criterion for disbursing the management fee. A Panel member suggested the Government negotiate with TWDC for pegging the base management fee to a percentage of earnings after interest, tax, depreciation and amortization.

Investment return and economic benefits

15. In a LegCo question raised at the Council meeting, a Member suggested that value for money audit on the tourism infrastructure projects, including HKD, should be conducted to assess their performance. Given the unsatisfactory park attendance in the past and the discrepancy in the economic assessment of the expanded HKD project and attendance projections made by TWDC and the Government, some Members had grave doubts about the viability of HKD, and whether the new agreement would serve the best interests of Hong Kong people. In particular, these Members questioned the reliability of the projection of investment return on HKD as some financial data were not made available by TWDC. A Panel member pointed out that both direct and indirect investment in the project, such as the reclamation work at the initial stage of development and the waiving of claims for dividends for the Mass Transit Railway in the construction of the Disneyland Resort Line, should be taken into account in calculating investment return. There were also concerns about the constraints imposed on the conversion of the \$4 billion subordinated shares that represented land premium to ordinary shares following the park expansion¹⁰.

16. As regards the creation of job opportunities under the expansion project, some Members stressed that priority be given to employing local labour force, in particular those Imagineers who had been laid off by TWDC previously. It was also suggested that HKD should employ more persons with disabilities to take up full-time positions in the theme park.

Latest development

17. TWDC has agreed to make annual disclosure of main operating and financial results of HKD, including park attendance and key indicators of financial performance as detailed in the Appendix, starting from 2008-2009. In the disclosure in respect of the operation year of 2008-2009, the 2007-2008 figures will

¹⁰ In 1999, the Government and TWDC agreed, and FC approved, that the \$4 billion subordinated shares would be converted to ordinary shares progressively during the life of the HKD project to the extent that the park's operating performance exceeded the then projected "Base Case". Both sides also agreed that the \$4 billion subordinated shares would be converted in a gradual manner, to ensure that the benefits of the ordinary shares held by other investors would not be diluted substantially within a short period of time, and that the conversion would only begin after five years of HKD's operation to allow for fluctuation in business in the early operating years. The permitted conversion ceiling would thereafter rise by 5% per annum cumulatively, thus rendering full conversion of the subordinated shares within 25 years after park opening possible if the park's business performance could consistently exceed the projections at the time. In order to prevent excessive equity dilution in any one year, an annual cap of 10% on conversion was further agreed.

also be shown for comparison and reference. The Administration will update the Panel on the operation of HKD at the meeting on 25 January 2010.

References

18. A list of the relevant papers with their hyperlinks is in http://www.legco.gov.hk/database/english/data_es/es-hk-disneyland.htm.

Council Business Division 1
Legislative Council Secretariat
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Disclosure of information on Hong Kong Disneyland (HKD)'s operating and financial results

The Government and The Walt Disney Company have agreed to publish an annual business review of HKD, starting with the operation year of 2008-2009, that would disclose the following items:

Business indicators (for both the current and the immediately prior financial year, unless otherwise specified)

- Attractions and guest offerings opened/launched in the relevant financial year
- Guest satisfaction for overall theme park and hotel experience
- Total annual park attendance
- Increase/(decrease) in park attendance (indicate as a % change)
- Increase/(decrease) in per capita park guest spending (indicate as a % change)
- Hotel occupancy (indicate as a %)
- Increase/(decrease) in available hotel room nights (indicate as a % change)
- Increase/(decrease) in per hotel room guest spending (indicate as a % change)
- Percentage of visitors by place of origin (Local/China/International)
- Number of full-time and part-time staff employed during the financial year

Aggregate financial indicators (for both the current and the immediately prior financial year) in HK\$ millions

- Revenues
- Costs and expenses
- Earnings before Interest, Tax, Depreciation and Amortisation (EBITDA)
- Depreciation and amortisation
- Net finance costs
- Net profit/(loss)
- Non-current assets

- Current assets
- Non-current liabilities
- Current liabilities
- Net Assets/Liabilities
- Cash provided (used) by
 - operating activities
 - investing activities
 - financing activities
- Net increase/(decrease) in cash

In the disclosure in respect of the operation year of 2008-2009, the 2007-2008 figures will also be shown for comparison and reference.

(Source: Extracts from the Administration's supplementary information in LC Paper No. CB(1)2206/08-09(02) for the Panel on Economic Development meeting on 10 July 2009)