

For information on
26 August 2011

**LegCo Panel on Home Affairs and Panel on Development
Joint Subcommittee to Monitor the Implementation of
the West Kowloon Cultural District Project**

**Financial Strategy for the Implementation of
the West Kowloon Cultural District Project**

INTRODUCTION

In response to Members' request, the West Kowloon Cultural District Authority (the Authority) has prepared a paper to brief Members on the financial and other strategies for implementing the West Kowloon Cultural District (WKCD) project.

2. Members are invited to note the paper at **Annex**.

BACKGROUND

3. The one-off upfront endowment of \$21.6 billion (in 2008 Net Present Value) given to the Authority was approved by the Finance Committee on 4 July 2008 to cover the capital costs for implementing the WKCD project. The retail / dining / entertainment part of the WKCD development will be vested in the Authority to provide a source of recurrent income through rental proceeds to meet the operating costs of the arts and cultural facilities and related facilities.

4. Funding approval for the other communal and government facilities and related engineering works serving the whole WKCD development will be sought separately.

**Home Affairs Bureau
August 2011**

Paper from the West Kowloon Cultural District Authority

**Financial Strategy for the Implementation of
the West Kowloon Cultural District Project**

PURPOSE

This paper aims to inform Members of the financial strategy for the implementation of the West Kowloon Cultural District (WKCD) project.

BACKGROUND

2. The one-off upfront endowment of \$21.6 billion (in 2008 Net Present Value (NPV)) given to the West Kowloon Cultural District Authority (the Authority), as approved by the Finance Committee of the Legislative Council (LegCo) on 4 July 2008 per Consultative Committee Case (CC Case)^{Note 1} for the WKCD, was intended for:

- a) design and construction of various facilities (\$15.7B or 73%);
- b) major repair and renovation of various facilities (\$2.9B or 13%);
- c) collection costs and related costs for M+ (\$1.7B or 8%); and
- d) planning of the WKCD and project management (\$1.3B or 6%).

Other communal and Government facilities and related engineering works, such as roads, drainage, fire station, etc. which are designed to support the whole WKCD development (including residential, commercial and hotel developments) will be undertaken by the Government, and funding approval for such works will be sought separately.

Note 1 CC case refers to the recommendations of the Consultative Committee. The one-off upfront endowment of \$21.6 billion in 2008 NPV is the sum total of the estimated capital costs of all the various component parts of the WKCD project compiled on the basis of a detailed financial study conducted by the Financial Adviser GHK (Hong Kong) Ltd engaged by the Home Affairs Bureau to assist the Consultative Committee to assess the financial requirements for the project. The Consultative Committee on the Core Arts and Cultural Facilities of the WKCD (Consultative Committee) was appointed by the Chief Executive in April 2006.

CURRENT EXTERNAL ECONOMIC AND FINANCIAL FACTORS AFFECTING THE PROJECT

3. In developing the WKCD financial analysis, the Financial Advisor (FA), GHK (Hong Kong) Ltd, has adopted a set of financial assumptions to arrive at the estimated cost of \$21.6 billion (2008 NPV) to cover the capital project costs undertaken by the Authority. The major financial assumptions which have significant implications to the capital cost for the WKCD are shown in the table below:

Factors	Longer-term Assumption	Remark
(a) Construction Cost Escalation	2% per annum average	Nominal term, construction costs are assumed at 2006 price and escalated year on year to 2059. Taking into account the volatility and cyclical fluctuation of construction costs over the past 25 years, the FA considers it more prudent to adopt an average escalation rate of construction costs which is in line with inflation rate, rather than adopting a high short-term growth rate.
(b) Discount Rate (i.e. assumed to be equal to annual rate of investment return)	6.08% per annum average	Nominal term, all costs are discounted to 2008 NPV (composed of a 4% real discount rate per annum and a 2% annual inflation rate)
(c) Inflation Rate	2% per annum average	Government Economist's view as stated in the LegCo paper for the one-off upfront endowment was that Hong Kong's inflation over the very long run would tend to 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 advanced economies are around 2%.

4. The macro economic environment in the recent years was very different from the long-term assumptions used in the financial analysis prepared in 2006 for the CC Case. An update of the major financial parameters under the current situation is shown in the table below.

Factors	Current Situation
(a) Construction Cost Escalation from 2006 to 2010	According to Building Works Tender Price Index (BWTPI) of Architectural Services Department (ArchSD) for the public sector, the average BWTPI in 2010 was 61% higher than the average BWTPI in 2006. Similarly, Rider Levett Bucknall's (RLB) Tender Price Index (TPI) for private sector increased by 29% in the same period.
(b) Discount Rate (i.e. assumed to be equal to annual rate of investment return)	The Authority's rate of investment return in financial years 2009-10 and 2010-11 was 1.1% and 3.4% respectively.
(c) Inflation Rate	The increase of Hong Kong Composite Price Index in the past four years was on average about 2.3% per year. The Government revised on 13 May 2011 the forecast inflation rate for 2011 to be 5.5% and the medium range forecast for 2012-15 being average 3.5% per annum.

5. Construction costs, in general, had increased significantly over the past few years due to the high construction demand in the region and change in other macro economic factors. The CC Case assumed 2% per annum average throughout the project period of 50 years. For the short duration from 2006 to 2010, the average BWTPI published by ArchSD for Government projects shows a 61% increase in tender price. Hence there was a difference of approximately 49% (1.61 according to BWTPI/1.08 according to CC case at 2% increase per annum for 4 years) in the nominal value of the construction cost at the beginning of 2010 according to BWTPI as compared to CC Case. In the same period, the TPI published by private sector quantity surveyor firms for private projects also shows significant increase (i.e. 29%) though of a lesser extent (i.e. with a difference of about 19% (1.29/1.08) as compared to CC Case).

6. Discount rate was assumed to be the same as the investment return in the CC Case. The longer term overall target investment return of 6.08% per annum assumed in the CC Case has become difficult to achieve, given the short term nature of the project capital costs and the economic volatility plus low interest rates in the aftermath of the unforeseen global financial tsunami in 2008. A comparison of HKD and USD interest rates in December 2006 (the basis of the project's assumed rate of return), December 2010 and June 2011 shows that the 3-month HKD deposit was nearly 4% in December 2006 whereas it was about 0.2% in December 2010 and June 2011, and that the 3-month USD deposit was about 5.3% in December 2006 compared to about 0.3% in December 2010 and 0.2% in June 2011. The 3-year US Treasury was nearly 5% in December 2006 compared to below 1% in December 2010 and June 2011.

LATEST FINANCIAL AND INVESTMENT POSITION OF THE AUTHORITY

7. The Authority should manage its finance with due care and diligence and ensure the financial sustainability of its operation and management under the West Kowloon Cultural District Authority Ordinance.

8. While the project phasing and the related expenditures profile have yet to be finalized, the Authority has prudently managed its finance and investment since inception by taking into account a number of relevant investment considerations:

- a) Capital preservation;
- b) Meet project cashflow requirements;
- c) Optimize investment yield and achieve target yield;
- d) Target yield to cover inflation costs for short to medium-term and to maintain purchasing power; and
- e) Diversify portfolio investment risk and maturity profile.

9. Given the changes in some of the project assumptions and pending the finalization of project cashflow, the Authority has implemented a prudent interim investment strategy with a number of initiatives including:

- a) placement of about HKD10 billion with the Hong Kong Monetary Authority (HKMA) for six years maturing in 2016 with

a yield of 6.3% per annum in 2010 and 6.0% per annum in 2011; and

- b) placement of remaining funds of about HKD11.6 billion in short-term deposits (in HKD and RMB) with tenure of 1 year and less with yield of approximately 1.4% per annum for 2010/2011. Given that about 46% of the Endowment Fund has been placed with HKMA long term, the short-term deposits were considered prudent.

10. Although the overall target investment return of 6.08% per annum was not achieved in the past few years due to the prevailing market conditions, the interim investment strategy has enabled the Authority to achieve improvement in investment yield. The rate of return obtained for the Authority's Endowment Fund for the financial year ended March 2011 was 3.4% per annum compared to 1.1% per annum for financial year ended March 2010 and 1.4% per annum for the period from 11 July 2008 (when the Authority was established) to 31 March 2009. Preparatory works and construction for the early phase of core arts and cultural facilities will start after the approval of the Development Plan and fulfilling the relevant statutory and land grant requirements. In this regard, a substantial portion of the endowment must be invested in short to medium term tenor matching with the project cash flow requirements in 2011-2015. This constrains the Authority from making investment in higher expected yield but more volatile asset classes. The yield improvement is achieved through an optimal trade-off between return and risk, with a consistent philosophy to avoid high risk/high return exposure.

11. The Authority will continuously explore investment alternatives to enhance yield based on a balanced approach to achieve risk/return/liquidity objectives, including the evaluation of the investment types, currency mix and tenure.

12. As the construction costs are expected to be volatile in the near term, the timing of tender can have significant impact on project cash flow and needs to be monitored closely. Taking into account the need for organic growth (see 13 (a) below), the facilities in WKCD will be developed in phases and the initial funding requirement will be dependent upon the content of the early phases of project development. Once the project

assumptions and timing of expenditures are established, a long term investment strategy will be defined with the aim of meeting funding requirement at different phases while optimizing risk and return.

FINANCIAL AND OTHER STRATEGIES FOR IMPLEMENTATION OF THE PROJECT

13. In view of the issues brought up in the above and in order to adopt a prudent financial strategy in implementing the WKCD project, the following approaches in resolving the challenges are proposed :-

a) Phasing and cash flow:

To review and develop an optimal and sustainable phasing arrangement for the core arts and cultural facilities, taking into account the need for organic growth. The Authority has conducted a series of engagement meetings to seek stakeholders' views on the priority, artistic positioning and technical requirements of core arts and cultural facilities. There is general support for developing the arts and cultural facilities in phases which would better meet the dynamic and changing needs and demand of the arts and cultural sector over a longer time span and allow better co-ordination of the software and hardware development. Developing the facilities in phases would also allow the Authority to retain a portion of the endowment for investment which will be beneficial to the cash flow and budgeting.

b) Procurement strategy review

To actively explore and adopt, where considered favourable, innovative procurement modes for the core arts and cultural facilities to achieve the most effective use of financial resources. Many factors have to be considered including the importance of architectural merits, timing, administrative and change control, cost and future maintainability. Following the initial financial studies under the CC Case, the possibility of private sector

involvement in project procurement will also be further reviewed.

c) Value engineering

To exhaust all possible measures during the planning and detailed design stage in cost planning and value engineering to attain the highest cost-effectiveness without compromising the overall venue quality and provisions. This has to bear in mind that a world-class arts and cultural district is to be developed with many of the key venues having to meet best in class quality.

d) Expand revenue sources

To actively explore alternative sources of revenue, including sponsorship, naming right, donation, etc.

e) Design and life cycle cost

To encourage and adopt innovative design that can save capital and life cycle cost. Innovative and aesthetically pleasing design may also be cost effective. As the Authority is also responsible for the future major renovation, maintenance and operation of the arts and cultural facilities and related facilities, the life cycle costing and maintainability aspects of the design have to be carefully reviewed.

f) Reduction of car park numbers

To actively look into the possibility of reduction of car parking for venue goers and encourage the use of public transport. Connectivity to all modes of public transport is to be enhanced. Due to floor area constraint, many of the car parks if required have to be provided underground. Reduction of car parks will help lower construction and maintenance costs.

SOFTWARE DEVELOPMENT

14. Notwithstanding the changes in macro economic factors and the escalation in project cost, the Authority has been organizing performing arts and visual culture programmes to build audiences and nurture talents for WKCD. The programme directions are as follows:

a) Performing Arts and Visual Culture programmes in the community, audience building activities

To link WKCD with the community and nurture and grow local audience base, the Authority has supported some community programmes held on and off the WKCD site, such as the “Yau Ma Tei Cultural Celebration project” organized by the Hulu Culture and “Hong Kong International Jazz Festival 2011: WKCD Concerts” organized by the Hong Kong Jazz Association. A number of community and audience building programmes in collaboration with local educational and arts institutions are under planning.

b) Capacity building partnership projects

To nurture artistic and administrative talents and to establish an international network, the Authority has launched several conferences and seminars in collaboration with educational and arts institutions, such as the “Advanced Cultural Leadership Programme “ organized by the University of Hong Kong in association with the Clore Leadership Programme, U.K., “2011 Cultural Leadership Summit” organized by Hong Kong Arts Administrators Association and “Forum of Intangible Cultural Heritage (Performing Arts) of Asia” organized by Zuni Icosahedron. The Authority will organize more capacity building projects in the coming years.

15. Meanwhile, the Authority intends to organize interim programmes and activities in part of the WKCD. This can help to:

- a) utilize the WKCD site before commissioning of the Phase 1 facilities and providing opportunities for outdoor and/or indoor events;
- b) raise public awareness of the future uses of the site;
- c) act as incubators for developing talents in performing arts and visual culture, plus associated venue management and other professional/technical skills;
- d) pilot the integration of software building with hardware development; and
- e) provide the Authority with a foretaste of running a site with mixed commercial and cultural activities, and balancing the two to achieve a financially sustainable and viable operation for the WKCD.

WAY FORWARD

16. The Authority will adopt a prudent financial strategy, as set out in paragraph 13 above, to implement the WKCD project. Investment alternatives will be continuously explored to enhance yield based on a balanced approach to achieve risk/return/liquidity objectives.

West Kowloon Cultural District Authority
August 2011