

NOTE FOR FINANCE COMMITTEE

Update on the Financial Situation of and Arrangements for the West Kowloon Cultural District project

PURPOSE

At the meeting of the Joint Subcommittee to Monitor the Implementation of the West Kowloon Cultural District Project (Joint Subcommittee) of the Legislative Council (LegCo) on 28 May 2014, the Government and the West Kowloon Cultural District Authority (WKCD) provided the Joint Subcommittee an update on the financial situation of and arrangements of the West Kowloon Cultural District (WKCD) project. A paper was issued to the Joint Subcommittee on this subject for the meeting. This note provides the information contained in the said paper for Members' information.

BACKGROUND

Granting of an upfront endowment to WKCD

2. Finance Committee (FC) of the LegCo approved an upfront endowment in the sum of \$21.6 billion (in 2008 Net Present Value (NPV)) in July 2008 (via PWSC(2008-09)31) for WKCD to implement the WKCD project. The broad breakdown of the estimated costs¹ is set out below –

- (a) Design and Construction of Various Facilities (\$15.7 billion);
- (b) Collection Costs and Related Costs for M+ (\$1.7 billion);
- (c) Major Repair and Renovation of Various Facilities (\$2.9 billion); and
- (d) Planning of the WKCD and Project Management (\$1.3 billion).

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¹ These are the capital costs for the WKCD project estimated by the Financial Advisor to the Consultative Committee on the Core Arts and Cultural Facilities of the WKCD based on a set of assumptions which formed the basis of the funding application to FC in 2008. The FC noted at that time that the actual capital costs amongst the different categories and facilities would have to be computed by WKCD following detailed planning and budgeting.

3. Members were also advised in 2008 that other communal and government facilities and related engineering works, such as roads, drainage, fire station, public pier, etc. which are designed to support the whole WKCD (including residential, commercial and hotel developments, the land proceeds of which will accrue to the Government) will be undertaken by the Government. Funding approval for such works will be sought separately by the Government in accordance with the development programme².

4. Following the approval of the upfront endowment fund, WKCD conducted a three-stage public engagement exercise from 2009 to 2011 to prepare a Development Plan (DP) for the WKCD. WKCD thoroughly analysed public comments and selected Foster + Partners' "City Park" conceptual plan in March 2011 as the preferred option for developing into a DP. Following the statutory planning procedures, the DP was approved by the Chief Executive-in-Council in January 2013. This forms the basis for the WKCD development. Additional features proposed in Foster + Partners' conceptual plan and included in the DP like the integrated basement and green initiatives were not envisaged when working out the funding application of the \$21.6 billion endowment approved by LegCo in 2008.

5. There has been significant escalation of construction costs since the approval of the endowment in 2008. With reference to the Architectural Services Department's tender price indices (TPI) for building works in the public sector, there was a continuous upsurge in construction costs in the past few years (112% from the third quarter (Q3) 2006³ to the fourth quarter (Q4) 2013). This upward trend is expected to continue in the next few years in light of the Government's infrastructure and public housing programmes.

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² In January 2013, the FC approved the PWP item 7753CL with an approved project estimate of \$478 million for the design and site investigation of government infrastructure works for supporting phase 1 of the WKCD development. The scope of the project comprises the design and site investigation of underground and at-grade carriageways, a flyover, four pedestrian linkage systems, underground stormwater and sewerage systems, underground fresh and salt water supply systems, berthing/landing facilities for vessels, and other ancillary works. The project commenced in Q4 2013 for phased completion from early 2014 to end 2017. In addition, the design and site investigation for the proposed advance works adjoining M+, comprising foundations, protection works for the Airport Express tunnel and essential enabling works for supporting the topside developments with an estimated cost of \$27.3 million, were funded as a block vote item. The design and site investigation works started in end-March 2014 to enable the proposed advance works to commence in August 2014 and complete in stages tentatively from end 2015 onwards.

³ The estimated costs in the recommendations of the Consultative Committee on the Core Arts and Cultural Facilities of the WKCD (CC Case) were prepared by the Financial Advisor in 2006. The Building Works TPI has gone from 751 in Q3 2006 to 1 590 in Q4 2013.

6. On the other hand, the global investment markets have experienced a significant decline in investment rate of return and high volatility. For reference, the compound nominal annual investment return generated by the Exchange Fund has decreased from 7% over the 14-year period from 1994 to 2007 to about 2% over the six-year period from 2008 to 2013. Despite the fact that WKCDA managed to increase the annual investment rate of return from around 1% in 2008-09 to around 4% in recent years, the actual rate of investment return is significantly lower than the assumed rate of 6.1% in the CC Case.

A pragmatic approach to implement the WKCD Project

7. In view of the challenges faced by WKCDA as cited above, the Government and WKCDA announced on 28 June 2013 that a pragmatic approach would be adopted to implement the WKCD project along the following principles –

- (a) rigorous cost containment of individual facilities to a level as close to the CC Case as possible;
- (b) emphasis on content rather than form of these facilities; and
- (c) early delivery of the Park as well as some arts and cultural facilities for public enjoyment.

Encl.

8. To address the funding gap, it was mentioned in the announcement that the Park and core arts and cultural facilities in the WKCD would be delivered in three batches (see Enclosure) and the following steps would also be taken in implementing the WKCD project –

- (a) Government would fully fund the integrated basement in addition to public infrastructure works (roads, drains, sewerage etc.), subject to funding approval by LegCo; and
- (b) WKCDA would proactively explore donation and sponsorship through naming rights.

9. To maximise the development potential of the WKCD site, WKCDA would, with Government's support, seek a minor relaxation of the development intensity of the WKCD site, yielding additional gross floor area (GFA) for various uses⁴.

/LATEST

⁴ WKCDA submitted a planning application for minor relaxation of GFA and building height restrictions to the Town Planning Board on 21 March 2014. The related capital cost for the additional GFA attributable to WKCDA will be determined after obtaining approval of the planning application as well as the proposed uses of the extra space and has not been included in the following analysis. WKCDA will consider looking into alternative funding sources to meet part of the related capital cost.

LATEST DEVELOPMENTS AND FINANCIAL POSITION

Integrated basement

10. With the Government's commitment announced last year to fully fund the integrated basement mentioned in paragraph 8 above, the Government now plans to develop the integrated basement **in phases** and aims to submit a funding application to LegCo for foundations for the advance public infrastructure works in the basement of M+ together with that for the design for the portion of the integrated basement adjoining M+ before the end of the current LegCo session. Details of the latest development of the integrated basement are set out in LC Paper No. CB(2)1591/13-14(03).

Artist Square Development Area

11. WKCDA proposes to accelerate the development of the area around the Artist Square, comprising M+, Lyric Theatre, other arts and cultural facilities (OACF), retail/dining/entertainment (RDE) facilities as well as office/residential developments, into a mini-WKCD, which is targeted for completion by around 2020. This area, to be referred to as the Artist Square Development Area (ASDA), will form a precinct supported by a balanced mix of various land uses to facilitate "destination building" in the early phased development of the WKCD and enhance vibrancy in the vicinity of M+. Moreover, the provision of RDE facilities in ASDA will generate income for WKCDA to meet part of the operating expenses of the Batch 1 facilities. A detailed account of the proposed ASDA is set out in LC Paper No. CB(2)1591/13-14(03).

Overall financial position

12. As a result of WKCDA's prudent financial management, the original endowment of \$21.6 billion approved by LegCo in 2008 has grown to \$23.7 billion by the end of the financial year 2013-14, after netting off all expenses incurred since the establishment of WKCDA in 2008.

Investment Return

13. The accumulated return on investment of the endowment fund since 2008 up to 31 March 2014 is \$3.8 billion. It represents an average annual return of 3% on investment. WKCDA projects that a further \$2.8 billion investment return from 2014-15 to 2018-19, making a total investment return of \$6.6 billion.

/Design

Design and Construction of Various Facilities

14. Based on the information currently available and on the premise that the integrated basement will be funded by the Government subject to funding approval by LegCo, it is estimated that the portion of funds for the Design and Construction of the WKCD facilities⁵ (i.e. \$17.8 billion⁶, with \$15.7 billion from the endowment and the apportioned interest income of \$2.1 billion) will be sufficient to cover the costs of the design and construction of the Batch 1 and Batch 2 facilities, as well as other related facilities including RDE and OACF.

15. Regarding the progress of the Batch 1 facilities, the construction of foundation works of Xiqu Centre has commenced last year and the schematic design of M+ has been completed earlier this year. The design consultants for the Park (who will also be responsible for the design of Freespace) and the Arts Pavilion have been selected and the designs of these facilities are now in full swing. The design consultancy for the Lyric Theatre has also been awarded last month. WKCD will strive to work according to its target of delivering these facilities in stages.

16. As for the Batch 3 facilities, comprising venues such as Music Centre, Great Theatre and Musical Theatre etc., it is relevant to note that there was no definite timetable for the delivery of these facilities and there was a need to align with the construction programme of the integrated basement. In light of the cost escalation and the indication made by the Government last year that there are no plans to seek additional funding injection into WKCD before completion of the Batch 1 facilities, WKCD and the Government will critically review the implementation programme of the Batch 3 facilities taking account of the costs of construction of the first two batches of facilities, changes in circumstances in the local arts scene and relevant stakeholders' views.

Collection Costs and Related Costs for M+

17. From the \$1.7 billion in 2008 NPV portion of funds for the collection and related costs of M+, \$271 million has been spent as at end 2013-14 as M+ started to make acquisitions in 2012-13. M+ will continue to expand its collection until the opening of the museum and beyond. Currently, around \$150 million to 200 million is budgeted per year for the next three years on collection acquisitions.

/Major

⁵ Some core arts and cultural facilities, viz. Musical Theatre and Mega Performance Venue/Exhibition Centre Complex, are subject to alternative funding options and are not covered by this portion of funds.

⁶ Does not include capitalised staff costs and site management costs directly related to this category.

Major Repair and Renovation of Various Facilities

18. \$2.9 billion in 2008 NPV was the original estimated requirement for major repair and renovation of the WKCD facilities in the CC Case. As the WKCD project is still at the planning and construction stage, no expenses have been required for major repair and renovation and are expected to be incurred in the next 20 years.

Planning of the WKCD and Project Management

19. When the Financial Advisor estimated the capital costs for the WKCD project, it was assumed that the facilities would be delivered in two phases and Phase 1, which consists of more than ten venues, would be completed by 2014-15. The long lead time required for conducting the three-stage public engagement exercise from 2009 to 2011, the preparation of the DP and the announcement last year to develop the WKCD facilities by batches means that the development timeframe for the WKCD project has been extended. Hence, it is obvious that the planning and project management stage will span over a much longer timeframe than was envisaged when the \$21.6 billion was approved by LegCo.

20. The results of the three-stage public engagement exercise indicated that the public and stakeholders supported an **organic growth** approach for the WKCD development. In view of public concerns over the financial situation of WKCD last year, WKCD further refined the phasing arrangement for the core arts and cultural facilities to better align with this guiding principle in June 2013. The current implementation programme of delivering facilities in three batches would allow WKCD to more closely monitor the project cost and formulate financial strategy to make the best use of the available resources, taking into account relevant factors like the development programme of the integrated basement, fluctuations in construction prices, inflation, investment returns etc., while building through the proposed ASDA and delivering a sufficiently critical mass of facilities in the initial stage to create vibrancy in the district.

21. In addition to the extended development timeframe and the resultant increase in the cost of planning and project management, feedback received during the public engagement exercise as well as engagement sessions, and the high expectations among the community, in particular the arts and cultural sector, all suggested that WKCD should not be a mere venue operator or hardware provider but should also play a key role in the promotion of the cultural software development of Hong Kong as well as arts education. Hence, prior to the commissioning of the WKCD facilities, WKCD has also been organising pre-opening programmes for performing arts and visual culture to enhance public awareness, groom arts talents and build audiences as part of the area marketing

/expenses

expenses for the WKCD project. Such software development⁷ is considered vital to the success of the project and WKCD has long been pressed by the arts sector to do more in this respect. However, this has inevitably increased the planning cost of the WKCD project.

22. By the end of 2013-14, the accumulated expenditure on the planning and project management is \$0.9 billion. Based on currently available information, it is estimated that an additional \$1.9 billion might be incurred by the end of 2018-19. The total expenditure of \$2.8 billion would be covered by the portion of the endowment (i.e. \$1.3 billion) plus the investment return of the endowment fund.

Operating Deficits of the Batch 1 Facilities

23. It was mentioned in PWSC(2008-09)³¹ that the RDE income will be used to meet the operating deficits of various facilities and WKCD's costs. It was also estimated in the CC Case that an annual RDE income of \$0.55 billion (in money-of-the-day (MOD) prices) would be generated from 2014 in the original plan when the WKCD migrates from planning stage to operating stage. Due to the extended development timeframe, the WKCD project will remain in the construction stage for a longer period of time and the realisation of RDE income would occur at a much later period than originally envisaged. Based on information currently available, the total amount of RDE income that would be received by WKCD was estimated to be less than \$0.1 billion per year by 2018-19. After taking into account of this RDE income, it is estimated that the operating deficits of the Batch 1 facilities first appear in 2014-15 of about \$0.05 billion would be about \$0.4 billion in 2018-19. WKCD expects that it will be necessary to use funds from the endowment fund to offset these initial operating deficits.

24. Meanwhile, WKCD is proactively exploring fundraising opportunities such as donations and sponsorships through naming rights (likely to be applicable for certain parts of the venue instead of the whole venue) to raise funds to cover expenses on cultural software development such as programming, audience building, arts education and cultural exchange. However, in the interim

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⁷ In the past two years, WKCD continued to develop cultural software for the WKCD project and the local cultural sector as a whole. In terms of audience building, WKCD organised a wide array of performing arts and visual culture programmes including Freespace Fest, West Kowloon Bamboo Theatre, Mobile M+: INFLATION!, Building M+: The Museum and Architecture Collection Exhibition, Mobile M+: 'You.' - Lee Kit, as well as the recent online exhibition Mobile M+: NEON SIGNS.HK etc., which successfully attracted hundred thousands of people to participate in the events. In addition, WKCD was dedicated to artistic and professional development through taking forward different capacity building initiatives, such as Xiqu Centre Seminar Series, The Arts-ray Series, M+ Matters Series, M+ Docent Volunteer Programme as well as internship programmes at M+ and Performing Arts Departments etc., which served to facilitate cultural exchange as well as equipping upcoming local arts administrators with hands-on work experience.

phase the funds raised from these alternative sources may not be sufficient to cover the expenses for cultural software development or help reduce the operating deficits of the Batch 1 facilities. It may therefore still be necessary to use funds from the endowment fund to offset part of the operating deficits of the venues.

PROGRESS OF COST CONTAINMENT AND BUDGETARY CONTROL

Cost containment measures

25. In line with public expectations and that of the LegCo, WKCD A attaches great importance to the financial management of the project. It has been adopting a pragmatic approach to develop facilities that are fit for purpose according to the principles mentioned in paragraph 7 above. WKCD A has exercised the following measures to contain cost –

- (a) conducted rigorous value engineering exercises for Xiqu Centre, with a view to reducing the construction cost through value engineering without compromising its functionality and quality;
- (b) started rigorous negotiations with the design team of M+ to further contain cost within the target budget of \$5 billion (in MOD prices) inclusive of fees;
- (c) adopted a simple and functional design for the Park, including the Black Box and Outdoor Stage in Freespace;
- (d) set a target to contain cost to a level as close to the target budget of \$1 billion as possible for the Park (including retendering the Park design consultancy) and Arts Pavilion⁸; and
- (e) conducted a critical review to minimise the growth of operating expenses and staff costs in the coming years.

Other budgetary control initiatives

26. Aiming at further budgetary control, WKCD A will continue to proactively implement/consider the following cost containment measures/revenue generating initiatives –

- (a) proactively seek sponsorship/income sources for arts and cultural programmes (e.g. leased the West Kowloon Bamboo Theatre for

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⁸ The design competition for the Arts Pavilion was launched in September 2013 with announcement of results on 23 January 2014. The winning design team was VPANG architects ltd + JET Architecture Inc + Lisa Cheung, a joint partnership of three local architects. Their winning design was well received by the public as well as the Joint Subcommittee at the meeting on 24 January 2014. The target completion of the Arts Pavilion is scheduled for 2015.

commercial theatrical productions, secured venue sponsor for Building M+ exhibition etc.) and explore various potential fundraising initiatives (e.g. devise plan on raising funds through granting naming rights of certain parts of the WKCD facilities, incorporate fundraising functions in the website, establish charity vehicle to encourage philanthropic efforts through tax deductible incentives etc.);

- (b) accelerating the implementation of ASDA as mentioned in paragraph 11 so that the higher RDE income can come on stream earlier and vibrancy of the district can be enhanced;
- (c) consider other financing/funding options for meeting timing difference of cost and revenue;
- (d) critically review the central management, planning and support cost; and
- (e) consider more cost effective operation models in order to optimise functionality and the mix of revenue/cost of different arts and cultural facilities.

27. With RDE facilities coming on stream later, the relevant rental proceeds will gradually increase to offset the operating deficits. WKCD will continue to closely monitor and review the financial situation from time to time, bearing in mind the importance of prudent financial management and its accountability to the public on the effective use of public funds.

Continuous financial monitoring

28. As committed to LegCo in July 2013, WKCD has no intention to seek further injection to the upfront endowment fund prior to completion of the Batch 1 facilities. However, for accountability and transparency purposes, WKCD undertakes to closely monitor the project's overall financial situation and present **annual** updates to LegCo and the public. This should take account of the progress made in those budgetary control measures adopted and likely changes to the development programme of the WKCD, for example, the early delivery of ASDA.

Implementation Programme of Major WKCD Facilities

A. Proposed in the CC Case for funding application in 2008

Phase 1 facilities (Target completion and operation in 2014-15)	Phase 2 facilities (Target completion and operation in 2026 for performing arts venues, and 2031 for M+ extension)
Great Theatre 1	Great Theatre 2
Xiqu Centre (performance venue)	Medium-sized Theatre 3
Xiqu Centre (small theatre)	Medium-sized Theatre 4
Concert Hall	M+ (Phase II)
Chamber Music Hall	
Medium-sized Theatre 1	
Medium-sized Theatre 2	
Blackbox Theatre 1	
Blackbox Theatre 2	
Blackbox Theatre 3	
Blackbox Theatre 4	
Mega Performance Venue	
Exhibition Centre	
M+ (Phase I)	
Public Open Space	

B. In the DP approved in January 2013

Phase 1 facilities (Target completion in 2014-2020)	Phase 2 facilities (Target completion beyond 2020)
Arts Pavilion	M+ (Phase II)
Great Park (Early portion of the Park)	Great Theatre
Xiqu Centre (Main Theatre, Tea House and Arts Education Facility)	Medium Theatre II
Freespace (with Music Box) and Outdoor Theatre	Xiqu Small Theatre
Centre for Contemporary Performance (three Blackboxes and Arts Education Facility)	
M+ (Phase I)	
Lyric Theatre	
Medium Theatre I	
Music Centre (Concert Hall, Recital Hall and Arts Education Facility)	
Mega Performance Venue*	
Exhibition Centre*	
Musical Theatre*	

* Subject to alternative funding options.

C. Under the pragmatic implementation approach in June 2013

Batch 1 facilities[#] (Target completion by 2017)	Batch 2 facilities[#] (Target completion by around 2020)	Batch 3 facilities[#] (Target completion beyond 2020)	Not phased
Xiqu Centre (including Tea House)	Lyric Theatre	Musical Theatre*	Mega Performance Venue/Exhibition Centre Complex*
Freespace (including Outdoor Stage and Black Box)	Centre for Contemporary Performance (including three Blackboxes)	Great Theatre	
M+	Medium Theatre II [@]	Music Centre (including Concert Hall and Recital Hall)	
Park (with Arts Pavilion)		Medium Theatre I	

Other arts and cultural facilities (including arts education facilities) will be provided in various parts of the WKCD.

@ WKCDA will explore the possibility and appropriateness to combine the development of Medium Theatre II and Centre for Contemporary Performance in order to achieve synergy in design efficiency and future operation.

* Subject to alternative funding options.
