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Panel on Economic Development
Meeting on 30 June 2009

Background brief on
Proposed expansion of Hong Kong Disneyland

Purpose

This paper provides background information on the proposed expansion of Hong Kong Disneyland (HKD) and 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 to build HKD (Phase 1) at Penny's Bay[1]. A joint venture company, the Hongkong International Theme Parks Limited (HKITP), was set up for this purpose[2]. The then estimated total project cost of developing HKD Phase 1 was $14.1 billion, in addition to an estimated of $4 billion for the cost of reclaiming the land for Phase 1 of the project. There are five main agreements entered between the Government and The Walt Disney Company, which are set out in **Appendix I**. Details of the financing arrangements for HKD and subsequent phases of development are in **Appendix II**.

3. According to the Administration's assessment made in 1999, HKD would generate huge economic benefits for the Hong Kong economy, estimated to reach $148 billion over 40 years[3]. Opened on 12 September 2005, HKD received in

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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 The Government owns 57% of the shares in HKITP while The Walt Disney Company 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 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 The Walt Disney Company 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.

total 5.2 million visitors during the first year of operation[4], while the second-year attendance was lower than expected, registering only some 4 million. In 2007-2008, HKD's attendance grew by 8% year-on-year. 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 of 30 September 2008, the full time workforce engaged by HKITP the management company stood at approximately 4500 strong.

4. To improve the financial position of HKITP, The Walt Disney Company has agreed to waive the management fees and to defer payment of royalties for two years (i.e. 2007-2008 and 2008-2009). In end 2007, HKD has also negotiated with the 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 The Walt Disney Company, 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

5. To realize the benefits of the long-term investment in HKD, the Government and The Walt Disney Company commenced discussion in December 2007 on an expansion plan[5] for HKD which might involve a capital realignment of HKITP. The Government would carefully consider various financial options, including the long-term financial arrangement of HKD, and conduct feasibility studies. In considering these issues, the Government would take account of a number of factors, including the implications for Hong Kong as a leading tourist destination in the region, impact on HKD's attendance and business, incremental economic benefits with reference to tourist arrival and job creation, financial viability of the expansion project, and return on Government's investment in the HKD project..

Concerns expressed by Members on expansion plan

6. 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, value-for-money audit on HKD as well as injection of funds into HKD. Details are in the link in the references section.

7. At the policy briefing for the Panel on Economic Development (EDEV Panel) on 22 October 2007, members expressed concern about the low patronage of

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[4] Each year of operation of HKD starts in October and ends in September the year after.

[5] Phase 1 Site covers about 126-hectare of land which some 80 hectares has been developed. The current negotiation between the Government and The Walt Disney Company on the Park's expansion is related to the development of the remaining 40 hectares.

HKD and the Government's plans, if any, to inject funds to support the theme park's future development. Some members suggested that consideration be given to develop HKD with reference to the experience of other Disney theme parks.

8. At the meeting of the EDEV Panel on 21 December 2007, members raised concern about the expansion plan and the long-term financial arrangements of HKD. Members requested the Administration to exercise due prudence in studying the financial proposals and provide information on the park's financial performance for members' consideration. There was also a suggestion that The Walt Disney Company should inject more funds than the Government in meeting the future operational and development needs of the park. The Administration recognized the need to conduct a thorough study on all related issues, and subject to the consent of The Walt Disney Company, it also agreed to disclose relevant information, including the performance of the park, and the financing options for consultation with the Panel.

9. At the meeting on 24 October 2008 when the Secretary for Commerce and Economic Development briefed the EDEV Panel on the 2008-2009 policy initiatives, members asked about the progress of the expansion plan. In view of the recent financial tsunami, they were keen to ensure that the expansion plan would be taken forward in a commercially viable and sustainable manner. According to the Administration, The Walt Disney Company has shown much determination and sincerity in realizing the plan. While recognizing the merits of expanding HKD, the Administration indicated that it would examine the proposal carefully as the Government was a shareholder of HKITP.

10. At the meeting on 16 December 2008, members criticized that criticized that the park management had all along been reluctant to disclose the financial performance of HKD. Without such information, it would be difficult for members to consider the proposed expansion plan, especially with regard to the injection of Government funds. Some members questioned whether further public monies should be injected into the expansion project in view of the uncertainty of the investment return and the implications of capital realignment of HKITP. There was a suggestion that the Administration should take the opportunity of the expansion project to negotiate for more equitable terms for the Government.

11. At the special meeting of the Finance Committee held on 23 March 2009, members urged for higher transparency on the progress of the negotiations between the Government and TWDC on HKD's expansion plan. They also called for an early conclusion of the negotiations, otherwise, HKD would likely lose its appeal in the face of competition from new theme parks in the Mainland such as that in Shanghai.

Latest development

12. The Administration will update members on the proposed expansion of HKD at the meeting on 30 June 2009.

References

13. 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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Appendix I

Contractual Arrangements for the development of Hong Kong Disneyland

There are altogether five main agreements:

(a) Management Agreement which sets out the relationships between HKITP and the The Walt Disney Company (WD) subsidiary which will manage the park. The management fees which WD will earn for agreeing to manage HKD are structured to be a function of overall financial performance.

(b) Licence Agreement which sets out the arrangements whereby HKITP secures and pays for access to WD intellectual property. The licence fees which WD will earn for licensing its intellectual property to HKD are similar to those arrangements in Tokyo for Tokyo Disneyland and in Paris for Disneyland Paris.

(c) Shareholders Agreement which sets out the rights and obligations of the shareholders. The two principal shareholders will initially be the Government and WD, both of whom must contribute cash equity.

(d) Loan Agreement which sets out the terms and conditions of the Government loan to HKITP. The government loan carries with it interest cost obligations and must be repaid within 25 years.

(e) Master Project Agreement which is the main contractual document setting out the parties' responsibilities and undertakings in respect of design, construction and operation of HKD.

(Source : Extracts from the Administration's paper on "Briefing Paper - Hong Kong Disneyland" issued on 3 November 1999.)

Appendix II

Financing arrangements and subsequent phases of development of Hong Kong Disneyland

Financing

1. In 1999, the then estimated total project cost to Hongkong International Theme Parks Limited (HKITP) of developing Hong Kong Disneyland (HKD) Phase 1 was $14.1 billion in money-of-the-day (MOD) prices. This is in addition to the cost of reclaiming the land for Phase 1 of the project, which was estimated at $4 billion in MOD prices. The Government also needs to provide land, associated infrastructure and government, institution and community facilities to support the development of HKD. Details are set out below.

Land Grant

2. Under the Project Agreement reached between the Government and The Walt Disneyland Company (WD), a site of about 126 hectares at Penny's Bay, Lantau Island (the "Phase 1 Site") should be granted by private treaty to HKITP for 50 years, with a right to renew for a further 50 years, subject to an annual rent of 3% rateable value. The land premium is $4 billion, being the estimated pro rata cost of the reclamation and site formation.

3. WD's forecast of the financial performance of HKD (the "Base Case" [note 1]) showed that the project could cover the cash cost of building and operating the theme park and related facilities, but could not cover the cost of the land. Given the very substantial economic and other benefits that HKD would bring to Hong Kong, the Government agreed not to demand cash up front for the land premium, subject to certain conditions, the main ones being -

(a) the full premium would be paid in subordinated shares which would convert to ordinary shares progressively during the life of the project to the extent that operating performance exceeded the Base Case. In this way the Government would capture its fair share of the project's upside potential;

(b) WD would agree to take a significant initial equity stake and retain most of it for the life of the project. In this way the Government would ensure the sustained commitment to the project; and

(c) the Government would hold a majority stake initially to protect its interest, but with the ability to sell down subsequently to third party investors.

[note 1] The base case is based on several assumptions, including:
(a) The park opens in 2005
(b) The park's attendance in its first year of operation is estimated at 5.2 million
(c) The park gradually reaches full annual capacity of 10 million after 15 years

4. In order to ensure that HKD would remain attractive as a commercial venture to existing and potential third party investors, the subordinated shares would be converted in a gradual manner. This would ensure that the benefits of the ordinary shares held by other investors would not be diluted substantially within a short period of time. Moreover, to allow for fluctuation in business in the early years of HKD, both sides also agreed that conversion would only begin after five years of theme park operation. The permitted conversion ceiling would thereafter rise by 5% per annum cumulatively thus rendering full conversion of the subordinated shares possible 25 years after opening. In order to prevent excessive equity dilution in any one year there would be an annual cap of 10% on conversion.

Cost of construction

5. The Government and WD agreed that the cost of constructing HKD, at $14.1 billion should be financed by a mixture of debt and equity at a commercially prudent ratio of approximately 60:40. This translates to $8.4 billion in debt and $5.7 billion in equity.

6. Initially WD would put up $2.45 billion in equity for one-dollar shares and hold a 43% stake in HKITP. It would later be allowed to sell down but not below the level of 1.9 billion shares. The Government would initially put up $3.25 billion in equity for one-dollar shares in HKITP and hold a 57% stake. The Government could sell down its stake to a minimum of one billion shares up to the end of the first year of operation. Thereafter, it could sell its shares (and also any subordinated shares that convert to ordinary shares) without any requirement for a minimum holding.

7. The debt of $8.4 billion would be raised by a commercial loan of $2.3 billion and a Government loan of $6.1 billion, the latter repayable over 25 years from park opening. (Both loan figures include capitalized interest estimated at $0.7 billion). The reason for raising just over a quarter of the debt from the open market was that in the early years the project cash flows could only prudently cover loan servicing of that amount. Repayment of the Government loan would begin ten years after HKD opens when the commercial loan has been paid off.

8. To help the project in its early years, the Government loan would carry interest on a sliding scale as follows -

- Prime minus 1.75% from drawdown to the first eight years after park opening

- Prime minus 0.875% for the next eight years

- Prime for the next nine years

9. The following summarizes the financing of the project.

Funding Sources	Amount ($ billion)	% to total
Equity, of which	**5.7**	**40.4%**
- Government	3.25	23%
- WD	2.45	17.4%
Debt, of which	**8.4**	**59.6%**
- Government	6.1*	43.3%
- Commercial	2.3*	16.3%
Total	**14.1**	**100%**

* Including capitalized interest.

10. According to the information provided by the Administration in April 2005, as at 31 December 2004, a total of 2.02 billion have been injected to HKITP as equity, whereas the loan due from HKITP was amounted to $3.62 billion. In 2005-2006, the Government injections and the loan drawdown are expected to be $0.78 billion and $1.36 billion respectively.

Associated and supporting infrastructure

11. To implement the development of HKD Phase 1, the Government has to provide a fully formed and serviced site on reclaimed land at Penny's Bay including associated and supporting infrastructure and government, institution and community facilities. The major capital spending that the Government has committed so far in this connection includes the following:

Capital Works Reserve Fund	Estimated Total Spending
Reclamation and other infrastructure works (including, for example, connecting road works, costs of construction of Inspiration Lake Recreation Centre, expenses for cleaning up of the dioxin contaminated soil, and the compensation payable to affected fishermen)	13.6 billion
Land acquisition and clearance compensation	1.6 billion

12. On railway service, the Government and MTR Corporation Limited (MTRCL) entered into a Project Agreement on the implementation of the Penny's Bay Rail Link (now known as "Disneyland Resort Line" (DRL)) in July 2002. To finance the construction and operation of the DRL, the Government advised the Panel on Transport that the Government agreed to waive its claim for $798 million (in present value) worth of dividends that it could otherwise expect to receive as a shareholder from the MTRCL from time to time during the next few years. DRL commenced service on 1 August 2005.

Option for Phase 2

13. Under the Project Agreement, it had been agreed that HKITP should be given an Option to buy the site immediately to the east of the Phase 1 Site for a second phase of the development ("Phase 2 Site"). The Option is valid for 20 years from signature, with an automatic right to extend for a further five years and a conditional right to extend for a second five year period. The premium has been fixed at $2.812 billion (1999 prices, to be adjusted for inflation in line with Composite CPI) payable in cash or in such other manner as the parties may agree. The Option lapses after 20 years if it has not been exercised or renewed but HKITP may have two five-year extensions of which the second is conditional upon the target capacity of 10 million not being reached but the secondary target capacity of 8 million being reached. While the
land is subject to the Option, it may be used for a variety of temporary purposes provided these are compatible with the adjacent theme park.

Right of First Refusal

14. In due course the site to the east of the (intended) Phase 2 Site may also be reclaimed and available for disposal. In order to keep open the possibility of a third theme park, HKITP has sought a right of first refusal to buy that site at then prevailing market prices and on normal lease terms. In view of the substantial advantages for Hong Kong's tourism industry of a third Disney park going ahead in the same location, with obvious opportunities for synergy, the Administration has agreed to grant such a right which will be valid for up to 10 years from the date of exercise by HKITP of the Option or the expiry or surrender of the Option if earlier.

(Source : Extracts from the Background brief on Hong Kong Disneyland prepared by the LegCo Secretariat (LC Paper No. CB(1)340/05-06) for the Panel on Economic Services meeting on 28 November 2005.)