A. Introduction

The Audit Commission ("Audit") conducted a review of the management of the Hong Kong Housing Authority ("HA")'s commercial properties with focus on the following areas:

- management of retail premises;
- management of car parks;
- management of factory estates;
- performance measurement and reporting; and
- the way forward.

2. **Mr D W PESCOD, Director of Housing**, made an opening statement at the public hearing on 12 May 2011. The full text of his statement is in ***Appendix 18***. The supplementary information provided by the Housing Department ("HD") in May 2011 for the public hearing is in ***Appendix 19***.

B. Management of retail premises

<u>Day-to-day management of retail premises</u>

Mechanism of managing retail premises

3. According to paragraphs 2.7 and 2.8 of the Director of Audit's Report ("Audit Report"), HD frontline staff (or security guards) are required to conduct daily patrols of the HA's retail facilities and the HD has implemented a unit-to-unit inspection system since July 2010. Under the system, HD staff (or contractor staff in the case of outsourced premises) are required to visit each retail shop, market stall and cooked food stall within the 18-month cycle to check the shop/stall conditions and to detect any breach of tenancy conditions. Notwithstanding the requirements, Audit found that there were cases of suspected abuse or improper use of retail premises. There were also cases involving suspected gambling activities, retail premises not regularly open for business, and obstruction problem.

4. To ascertain whether the HD had effectively monitored the management of HA retail premises, the Committee asked about the HD's mechanism in place for monitoring the management of retail premises, particularly how the HD enforced its instructions and guidelines, and the reporting channels for frontline staff to report irregularities to the senior management.

5. The **Director of Housing** and **Mr LEE Kwok-wing, Deputy Director (Estate Management) of the HD**, responded that:

- the HD, as the executive arm of the HA, was responsible for day-to-day management of retail premises. The Deputy Director (Estate Management) was assisted by three Assistant Directors and their subordinates in managing all retail premises, including those directly managed by the HD and those outsourced to property management contractors ("contractors"); and

- the HD had issued clear guidelines to its staff on how to enforce the Housing Ordinance (Cap. 283) and the mechanism for reporting irregularities in retail premises. The Deputy Director (Estate Management) and the three Assistant Directors met weekly to review the management of retail premises.

6. The Committee further asked about the details of the reporting mechanism and whether irregularities would be reported to the senior management on a regular basis.

7. The **Deputy Director (Estate Management)** replied that:

- since nearly 70% of the retail facilities were outsourced to contractors for day-to-day management, the HD counted on the contractors to report any irregularities to the Assistant Directors through district chief managers and senior managers of individual estates; and

- the HD would also monitor the performance of contractors in each district regularly by inspecting their documents and conducting surprise checks. If there had not been any serious problems in the management of the estates, district staff might not report the irregularities to the senior management. When there were special issues of concern in the estates, district staff would report them to the senior management according to the reporting mechanism.

8. The Committee was concerned that although a reporting mechanism was in place, irregularities in retail premises still persisted over the years. To ascertain whether the HD had deployed adequate manpower to oversee the management of retail premises, the Committee asked:

- about the scope of duties of senior managers and their working location; and

- whether there was any requirement on the frequency of senior managers visiting housing estates.

9. The **Director of Housing** and the **Deputy Director (Estate Management)** replied that:

- duties of senior managers included tenancy management and estate management of all premises in the housing estates. At present, the HD deployed 16 senior managers to oversee the management of about 180 housing estates. In other words, each senior manager would oversee an average of 12 housing estates. Senior managers worked in the district offices; and

- HD staff were required to submit monthly reports on the premises managed by the HD while outsourced contractors were required to submit quarterly reports to the HD's senior management for monitoring purpose. Senior managers were required to review the reports and visit the housing estates under their charge quarterly. The HD was aware that some of the irregularities were deliberate acts by organised groups and could not be solved in the short term or simply by increasing the manpower.

10. The Committee queried why the HD was unable to detect the irregularities identified by Audit, despite that senior managers were required to visit the housing estates under their charge quarterly.

11. In response, the **Deputy Director (Estate Management)** and **Mr LIU King-leung, Assistant Director (Estate Management) 3 of the HD**, replied that the unit-to-unit inspection regime had only been implemented since July 2010. As senior managers oversaw the overall management of housing estates, apart from monitoring HD frontline staff and contractors in properly carrying out their duties of inspecting retail premises, they were also responsible for reviewing the operating expenditure of the estates, service standard provided by HD frontline staff and contractors, cleansing and security services, and dealing with complaints. As such, senior managers could only focus on the major issues of concern in the management of estates, such as by reviewing the inspection reports.

12. The Committee further asked whether housing managers would provide assistance to senior managers when senior managers conducted their quarterly visits of housing estates, such as by accompanying the senior managers and highlighting the major issues of concern in the estates to them.

13. The **Assistant Director (Estate Management) 3** replied that:

- housing managers would normally accompany senior managers on their visits to the housing estates. When irregularities were observed during the inspections by HD frontline staff and contractors, they would try their best to deal with the problems themselves. In case they were unable to deal with the problems with their existing resources, they would report to the headquarters for its support. Normally, housing managers and their subordinates were able to handle general and routine matters in the estates; and

- the HD was reviewing the scope of major issues of concern which should be reviewed by senior managers with a view to improving the management of retail premises. As there was a wide spectrum of management work in an estate, it would be difficult for senior managers to inspect every aspect in detail.

14. The Committee noted from paragraph 1.5 of the Audit Report that the Commercial Properties Committee ("CPC") was a standing committee of the HA and was responsible for advising the HA on policies concerning its commercial, industrial and other non-domestic facilities, and optimising financial return on its investment. In order to understand the role of the CPC in dealing with the irregularities in HA retail premises, the Committee asked about the frequency of the

CPC's meetings and whether there was a regular agenda item on reviewing the irregularities mentioned in the Audit Report.

15. In response, **Dr Andrew CHAN Ping-chiu, Chairman of the CPC**, said that:

- the CPC held nine meetings last year, including two special meetings and brainstorming meetings. The HD reported the overall occupancy and vacancy rates of retail premises to the CPC; and

- the CPC had also conducted site inspections to the HA's commercial, industrial and other non-domestic facilities. When the CPC observed any irregularities during the site inspections, it would refer them to the HD for follow-up. The CPC was aware that some let-out retail premises were not open for business (i.e. non-trading) and knew that there was at present no provision in the HA's tenancy agreements that required retail shops and cooked food stalls to open for business for any minimum hours per day or minimum days per week. The HD would review the feasibility to specify opening hours in tenancy agreements appropriate to the nature of business and customer demand in respect of the retail facilities, having regard to the best interest of the domestic tenants.

Suspected gambling activities

16. As reported in paragraphs 2.12 and 2.13 of the Audit Report, suspected gambling activities, such as groups of people playing mahjong/tin kau cards, appeared prevalent in some of the retail premises visited by Audit. The Committee noted that the HD was aware of the problem as early as 1997 and had issued an internal instruction requesting all estate housing managers to take positive action to deal with suspected gambling activities. The Committee asked:

- why gambling activities were still prevalent over the years despite the HD's instruction; and

- whether there were any loopholes in the system for dealing with the gambling problem.

17. The **Director of Housing** replied that:

- the HD worked closely with the police to enforce the law against serious institutionalised gambling which might involve commercial operation. Tenancy enforcement actions including issuance of notice-to-quit would be taken in case of conviction; and

- for day-to-day activities in common areas, such as individual tenants playing tin kau, the HD would try to persuade them not to do so by working with different agencies or organisations in the estates. The problem of gambling could not be solved completely and the HD was doing its best to deal with the problem within the means available.

18. As requested by the Committee, the **Director of Housing** provided a copy of the internal instruction issued by the HD in 1997 on dealing with gambling activities in Annex II of his letter of 16 May 2011 (in ***Appendix 20***). According to the instruction, HD staff (and contractor staff) were required to follow through the measures laid down in the instruction, which included forming small teams to patrol those areas known to the Estate Office with gambling activities and organising regular joint abatement action by estate staff and the police. However, the Committee noted from paragraph 2.14 of the Audit Report that there were cases in which gambling activities were not reported to the police and no notice-to-quit were served on a tenant who was convicted of illegal gambling. The Committee asked:

- whether the instruction was still in force, and why HD staff (and contractor staff) had not vigilantly followed the measures laid down in the instruction over the past 14 years; and

- whether a hotline had been set up for reporting suspected gambling activities.

19. The **Director of Housing** replied that:

- HD staff had been following through the measures laid down in the instruction. In the last year, the HD had carried out 150 joint exercises with the police to combat illegal gambling activities. There had been no discrepancy between the instruction and the actual practice; and

- there were hotlines which handled all sorts of complaints, including complaints on gambling.

20. The Committee noted that a marking scheme had been implemented in HA retail premises since October 2006 under which penalty points would be allotted according to the seriousness of misdeeds. Referring to Appendix C of the Audit Report which set out the scheduled misdeeds under the marking scheme, the Committee asked:

- about the reasons for not including improper and unauthorised use of retail premises, such as gambling, as misdeeds under the marking scheme; and

- whether the HD would consider modifying the existing marking scheme to cover uses of retail premises which were improper but might not be prohibited by law.

21. The **Deputy Director (Estate Management)** and the **Assistant Director (Estate Management) 3** responded that:

- the marking scheme was adopted with the objective of sustaining a clean, hygienic and tidy environment in retail premises. Under the existing practice, the HD would report all illegal gambling activities to the police immediately once they were found; and

- in some circumstances, termination of tenancies could be an effective means to deal with breaches of tenancy conditions. However, the HD would consider whether it would be feasible to establish a marking scheme to deal with improper use of retail premises.

22. Case 1 in paragraph 2.9 of the Audit Report revealed that there were two adjacent storerooms in a shopping centre in which an opening was made to the partition wall between them without the HD's approval. The Committee asked whether the HD would also consider modifying the existing marking scheme to cover unauthorised alteration of premises.

23. The **Assistant Director (Estate Management) 3** replied that:

- as there was a diversity of irregularities in retail premises, the HD considered it impossible to include all misdeeds in the marking scheme. The HD would follow up any breaches of tenancy conditions by issuing warning letters, conducting interviews with tenants and explaining to them that their behaviour was unacceptable. If the irregularities still persisted, a notice-to-quit would be served on the tenants concerned; and

- the two storerooms mentioned in Case 1 had already been recovered by the HD.

Retail premises not regularly open for business

24. The Committee referred to paragraph 2.17 of the Audit Report, which revealed that 33% of the let-out retail shops and market stalls in a shopping centre in Tsuen Wan were not regularly open for business. However, there was no provision in the HA's tenancy agreements of retail shops and cooked food stalls for regulating the non-trading problem. In the tenancy agreement for market stalls, the non-trading rule stipulated that the tenant should not cease to carry on business at the stall for more than seven consecutive days. Compared to the non-trading rule of the Food and Environmental Hygiene Department, the HA's rule seemed to be less stringent, as a tenant could open for business only one day per week without breaching the tenancy agreement. The Committee asked whether:

- the HD would review the non-trading rule stipulated in its existing tenancy agreements; and

- the HD maintained records on whether retail premises were open for business and the contents of such record, if any.

25. The **Director of Housing** and the **Deputy Director (Estate Management)** replied that:

- there were different reasons leading to the non-trading situation. Some sole proprietors, such as electricians, operated a shop but provided services elsewhere. As such, they could only open the shop for very limited times. There was another case in which a tenant operated a computer repair shop on a part-time basis. As long as he was providing the services, the HD did not consider that was a particular problem. Sometimes, business operators chose not to operate during normal business hours but operate in the evening or at night because of particular commercial location. The HD had to accommodate different situations and exercise flexibility as long as the businesses were operated in legitimate ways. The HD was reviewing the lease conditions in terms of operating hours and continuous business of the premises; and

- the HD maintained records on whether retail premises were open for business but such records were informal in the past. With Audit's recommendations, the HD had begun to maintain the records systematically.

Letting of retail premises and implementation of improvement measures

26. As revealed in Table 3 in paragraph 2.23 of the Audit Report, many HA retail premises had remained vacant for a long time. Of the 251 vacant retail premises, 122 had been vacant for more than three years, in which 91 had even been vacant for more than five years.

27. The Committee queried whether the HD had taken effective measures to let out the vacant retail premises or prompt actions to explore viable options to optimise their use, such as approaching those tenants who were forced to close their shops after The Link Real Estate Investment Trust ("The Link REIT") had taken over the HA's commercial properties and inviting young people to start their own business in the vacant premises.

28. As regards the vacancy problems in markets, paragraph 2.37 of the Audit Report stated that although re-ordering exercises had been conducted in a number of markets, there were still five markets with a consistently high vacancy rate of over 30% for the past five years. The Committee also pointed out that there were complaints about poor hygienic conditions, poor illumination, and lack of air-conditioning in the markets, resulting in low patronage and poor business. As such, the markets could not attract bidders.

29. Against the above background, the Committee asked:

- about the measures taken by the HD to let out the vacant retail premises; and

- whether the HD would allocate more resources to improve those markets with poor conditions so as to attract more tenants, or consider converting the markets to other gainful uses.

30. The **Director of Housing** and the **Deputy Director (Estate Management)** stated that:

- the HD had taken initiatives to reduce the vacancy rate of markets through market re-ordering, i.e. by grouping vacant market stalls together at one side of the market to create a better retail atmosphere, and conversion to other uses to suit residents' need. As a result, there had been a drastic reduction in the vacancy rate of markets from 22% in 2005 to 9% in 2011. The HD's objective was to attract more commercial tenants in order to keep the markets open, as closing down the markets would affect the services provided to domestic tenants;

- there had been a significant improvement in the overall vacancy rate of retail shops which had dropped from 7.6% in 2006 to 5% in 2011 through implementing a number of improvement measures. Given that some of the retail premises were old-aged facilities in unpopular locations with inferior accessibility, there had been a high vacancy rate in individual estates with unattractive retail facilities. Wah Fu (II) Estate was an example. It was situated on an upper platform and residents preferred buying food in the market of Wah Fu (I) Estate, which was located near a bus stop and on a lower platform;

- the HD would intensify its efforts to further reduce the vacancy rate of retail premises by adopting flexible letting terms and tendering procedures, such as conducting open instant tenders, offering short-term tenancy and longer rent-free period. The HD would also convert surplus facilities to other uses and implement major improvement works for asset enhancement. Tenants of The Link REIT were welcome to submit a bid for vacant premises;

- the HD had been considering improving those markets with poor conditions. However, some markets were designed long time ago and could not accommodate air-conditioning facilities at a viable cost. As such, the HD would look into other solutions to solve the problem. The CPC had approved the HD's proposal to earmark four major retail facilities (at On Kay Court, Pok Hong Estate, Wah Fu (I) Estate, and Wah Fu (II) Estate) for early consideration of major improvement works. The HD would also improve the accessibility of Wah Fu (II) Estate by adding lifts and escalators; and

- to attract more bidders for vacant retail premises, the HD also advertised vacancies of retail premises. Tender notices were published in leading newspapers every Friday and uploaded onto the HA's website.

31. The Committee further referred to Case 2 in paragraph 2.28 of the Audit Report which revealed that a vacant retail shop had been repeatedly re-designated for different trades, some of which were very similar, based on HD staff's own knowledge and experience in over 25 unsuccessful re-tendering exercises since 2004. The Committee asked:

- whether and when the HD would review the situation where there was no bidder of a vacant retail premises after several re-tendering exercises;

- whether the HD had conducted market research on the actual demand of vacant premises by commercial tenants, and whether it was aware that some industries or arts groups had difficulties in finding an appropriate premises for operation; and

- whether the HD had considered using those vacant premises with low commercial value as community facilities like study rooms.

32. The **Director of Housing**, the **Deputy Director (Estate Management)** and the **Assistant Director (Estate Management) 3** replied that:

- the HD had been reviewing Case 2 on an ongoing basis and identifying alternative uses of the premises to match the demand of potential tenants. While the HD was aware of the needs of arts groups for premises, it had to cater to the needs of domestic tenants for services like shops and restaurants. Regarding Case 2, the HD had repeatedly re-designated the vacant retail shop, which was located in Wah Fu (II) Estate, for different trades over the years with a view to attracting interested bidders. The HD had also conducted a strength-weakness-opportunity-threat ("SWOT") analysis to identify the causes of the problem. It was in the process of re-letting the shop and interested parties/potential tenderers were allowed to suggest possible trades;

- the HD conducted SWOT analysis to gather market information on a regular basis. For example, the HD had been studying comprehensive market information in respect of a new development in Yau Tong; and

- the HD had been converting vacant premises with low commercial value into community facilities. For instance, it had converted a vacant cooked food stall in Chak On Estate into a library and the vacant cooked food stalls in the Shun Lee Tsuen into a platform for residents to organise activities or carnivals. The HD had recently arranged with the Hospital Authority to take up a number of units in Wah Fu (II) Estate to provide an elderly care centre and an elderly education centre.

33. The Committee further asked:

- about the rank of staff who were involved in the conduct and review of tendering exercises for vacant premises; and

- when a case of no bidder in a tendering exercise would be brought up to the attention of staff at the Deputy Director or Assistant Director levels.

34. The **Assistant Director (Estate Management) 3** replied that:

- when a tenant terminated a tenancy and returned the premises to the HD, the senior housing manager of the Commercial Properties Support Services Section of the HD would study whether it would be appropriate to conduct an open tender to let out the premises, and a tendering exercise would be conducted where appropriate. For some special premises, the HD would let them out by direct negotiation and the prospective tenants on the client list of the selected trade would be invited to submit leasing proposals to the HD for consideration;

- the HD would take the advice of Audit to encourage prospective tenants to make trade suggestions when re-letting vacant retail premises with a view to letting out the premises as soon as possible; and

- the chief estate surveyors and the Assistant Directors concerned would review the vacancy rate of retail premises quarterly and look for alternatives to let out the premises if it had been vacant for four months.

35. The Committee referred to the HA's commercial operating account in Table 1 of paragraph 1.3 of the Audit Report and asked:

- why the expenditure on welfare premises was relatively low, as compared to that on retail premises, car park and factory estate; and

- whether the operating surplus had included those generated from properties directly managed by the HD and those outsourced to contractors.

36. The **Director of Housing** and the **Deputy Director (Estate Management)** responded that the commercial operating account referred to in Table 1 had included those managed by the HD and those outsourced to contractors. Since the occupancy rate of welfare premises tended to be stable and not much maintenance work was required, the expenditure incurred by the HD for welfare premises tended to be low.

37. As requested by the Committee, the **Director of Housing** provided further information on the commercial operating accounts and the 37 major retail facilities listed in Appendix B of the Audit Report in his letters of 16 May 2011 (in ***Appendix 20***) and 30 May 2011 (in ***Appendix 21***).

Monitoring of operating expenditure

38. According to paragraphs 2.45 to 2.47 of the Audit Report, there was a case in which the area of an estate belonging to welfare premises was wrongly regarded as retail premises. As a result, the actual area was overstated by nearly four times and the unit operating expenditure understated by about 80%. There were also cases in which the daily expenses, such as the security or cleansing expenditure, were not charged to the correct business accounts. As such errors could easily be detected, the Committee questioned why such errors occurred, and whether senior managers would cross check the accuracy of data input by HD frontline staff regularly.

39. The **Assistant Director (Estate Management) 3** responded that:

- at the beginning of each month, contractors would send the bills for settlement by the HD. After certifying the bills correct, payment would be made to the contractor. Management officers or housing officers would then input the data of the expenses, breaking them down into different types of business accounts, into the computer. As finalising the account of operating expenditure of the whole estate took about one to two months, some HD staff might not be aware of the errors in data if the overall operating expenditure did not exceed the HD's benchmarks. As regards the case mentioned in paragraph 2.45(c) of the Audit Report, the frontline staff concerned had input the data incorrectly by mistake;

- since senior managers were responsible for the overall management of housing estates, it was the responsibility of the Commercial Properties Support Services Section in the headquarters to check the accuracy of the operating expenditure. The HD had recently provided specific training courses on accounting guidelines and principles for charging business accounts to local management staff. With such measure, the HD hoped that its frontline staff would be able to input the data correctly in future; and

- according to the existing guidelines, the operating statements should be reviewed every three months. Apart from senior managers, district chief managers, Assistant Directors and Deputy Director concerned would also visit the estates regularly to ensure that the quality of overall management service met the required levels.

C. Management of car parks and factory estates

40. As stated in paragraph 3.2 of the Audit Report, of the HA's 117 car parks, 3% were directly managed by the HD whereas 97% were outsourced to private operators or carpark operators. The Committee asked why the HD still kept managing such a small portion of car parks. The **Assistant Director (Estate Management) 3** replied that since there were only few parking spaces in some estates, it would not be cost-effective to outsource the management of the car parks concerned.

41. The Committee then referred to paragraph 4.15 of the Audit Report, which stated that since 1989, it had been the policy of the HA to absolve itself from the ownership and management of factory estates in the long term ("the 1989 policy"). However, up to January 2011 (after more than 21 years), the HD had not formulated a long-term strategy to implement the 1989 policy. The Committee also noted that one of the six newer factory estates built in or after 1979 (i.e. Hoi Tai Factory Estate) had been running at a deficit for two consecutive years ($0.4 million in 2008-2009 and $0.9 million in 2009-2010). The Committee asked why the HD had still not implemented the 1989 policy after a long time.

42. The **Director of Housing** replied that:

- the HD reviewed the 1989 policy on a regular basis. In 2008, due to the economic downturn, the HD did not recommend closure, renovation or redevelopment of the Chai Wan Factory Estate ("CWFE"). In March 2011, the CPC approved a plan to clear the CWFE;

- for the six newer factory estates, they had an occupancy rate of nearly 99%. In view of the limited supply of small factory units in the private sector, some tenants would have difficulties in finding alternative accommodation in private industrial developments. The HD had recently obtained the agreement of the CPC to continue the management of the six factory estates and would review the situation from time to time; and

- the reason for the Hoi Tai Factory Estate running a deficit was that the HD had carried out a substantial renovation project in the building with a view to improving its standard and allowing its continuous operation.

43. It appeared to the Committee that following the agreement of the CPC to continue the management of the six newer factory estates, the HA's 1989 policy had since been changed. The Committee asked:

- when the CPC made the decision and whether the decision was made after the matter was raised by Audit; and

- whether the HD had informed the Legislative Council ("LegCo") about the policy change.

44. The **Director of Housing** stated in his reply of 31 May 2011, in ***Appendix 22***, that members of the CPC noted the continued demand for the 8,000 small factory units in the six newer factory estates of the HA at the meeting held on 28 April 2011. In view of their high letting rate (i.e. over 99%), CPC members supported the HD's proposal to continue managing them *pro tem* and to review the situation from time to time. The HD would inform the LegCo if there was a substantial change to the long-term policy on the ownership and management of the factory estates in future. He also provided a copy of the relevant CPC paper to the Committee.

45. The Committee noted that the CPC paper was issued on 20 April 2011 for the purpose of informing CPC members of the major findings, recommendations and the management response to the Audit Report, indicating that the modification to the 1989 policy was decided after the matter was raised by Audit.

46. According to Case 3 in paragraph 4.25 of the Audit Report, a tenant had ceased operation in four units of Factory Estate 1 for eight years and the premises had been sublet to different third parties for two to 11 years. Case 4 in the same paragraph of the Audit Report also revealed that a unit had been sublet to a third party as early as in February 2004. The Committee queried:

- why the HD could not detect the cases over the years; and

- whether HD staff had carried out the inspection of each factory unit regularly.

47. The **Assistant Director (Estate Management) 3** replied at the public hearing and the **Director of Housing** stated in his letter of 16 May 2011 that the HD requested its frontline staff to conduct unit-to-unit inspections on factory estates. Besides, the HD had revised the Factory Estate Operational Manual which provided guidance on patrolling and inspections. HD frontline staff was now required to complete and sign an inspection report for each unit and their supervisors were required to cross check their work. With such measures, the HD expected that cases of subletting factory premises would be detected more promptly.

D. The way forward

<u>The 2005 divestment exercise</u>

48. In July 2003, the Chief Executive in Council decided that the HA's agreement should be sought to divest its retail and carpark ("RC") facilities, and that the net proceeds from the divestment should entirely go to the HA. In the same month, the HA agreed in principle to divest its RC facilities. One of the reasons for the divestment was that with the cessation of construction and sale of Home Ownership Scheme flats, the HA lacked a recurrent source of income. Proceeds from the divestment would help the HA meet its funding requirements in the short term.

49. The HA decided that the divestment project would include 180 RC facilities. In addition, an REIT structure (i.e. The Link REIT) would be established and listed on the Stock Exchange of Hong Kong to hold the HA's RC facilities to be divested; and at a later stage when the preparation of relevant land leases was completed, the HA would transfer the legal title of the RC facilities to The Link REIT.

50. As revealed in paragraph 6.9 of the Audit Report, at the time when The Link REIT was listed in November 2005, the HA could only transfer to it the legal title of 76 divested properties. For the remaining 104 properties, only beneficial ownership was transferred at that time. According to The Link REIT's Initial Public Offering ("IPO") Circular, it was intended that the HA would transfer the legal title of the properties to The Link REIT in batches by mid-2008. As it transpired, the HA re-scheduled the completion date for the whole transfer project to July 2010 and the revised timeframe was eventually met.

51. The Committee noted from paragraph 6.13 of the Audit Report that although it was intended that the legal title of the remaining 104 divested properties would be transferred to The Link REIT in batches by mid-2008, there were 54 divested properties the legal title of which could only be transferred to The Link REIT after mid-2008. The late completion of the transfer process had caused a delay in charging government rent on the divested properties. Audit estimated that the financial implications (i.e. notional government rent chargeable from mid-2008 to July 2010) could have amounted to some $30 million.

52. Given that the late completion of the title transfer process had deprived the right of the Government to charge government rent on the divested properties from mid-2008 to July 2010, resulting in a loss amounted to some $30 million, the Committee asked about:

- the reasons for the late completion of the transfer of legal title of each of the 54 divested properties; and

- how the original target completion date of mid-2008 was set and whether it was a realistic target.

53. The **Director of Housing** replied that the original target date was decided after a lot of consultations. It was set based on assumptions and was considered to be a reasonable date at that moment.

54. In his letter of 24 May 2011 in ***Appendix 23***, the **Director of Housing** provided detailed reasons for the late completion of the title transfer process. He stated that the procurement of leases and Deeds of Mutual Covenant ("DMCs") after the sale of beneficial interest of the divested properties was an unprecedented task. The work involved in the procurement process was much more complex and onerous than could be anticipated at the time of planning and of divestment. During the procurement process, new requirements and restrictions were imposed by various government departments. There was also a host of other unforeseen issues seriously affecting the progress. In the light of the circumstances, it was necessary to revisit and revise the original target completion date for the transfer of legal title. The details were as follows:

Certification of gross floor area ("GFA") under lease

- new procedures and requirements on certification of GFA under lease were introduced by the Lands Department ("LandsD") in end 2005, shortly after the listing. Pending finalisation and issuance of the new procedures and requirements by the LandsD, progress of the programme was seriously affected until end 2006. Moreover, the changes resulted in considerably longer processing time for individual leases, which in turn significantly affected the overall programme;

Planning issues

- new planning requirements regarding carving out of free standing Government, Institution and Community facilities from lease boundaries and building height restrictions were raised by the Planning Department ("PlanD") in early 2007. The HD made repeated representations to the PlanD for not applying the new planning requirements to the remaining properties, particularly in relation to those leases of which approval in principle had already been granted by the LandsD. However, the PlanD considered that no exceptions could be allowed. Significant additional liaison work was thus required with relevant government departments on the determination of the revised boundary and on granting of appropriate rights and easements, including for those leases on which approval in principle had been granted by the LandsD. The lease finalisation work was inevitably deferred as a result. Subsequent preparatory works for DMC and title transfer were also seriously affected;

DMC issues

- the assignment programme had been further affected by revisions to the Model DMC required by the Legal Advisory and Conveyancing Office of the LandsD to align with the new DMC requirements. There were also changes necessitated by the legislative amendments then introduced;

Other complications

- the situation was further aggravated by unexpected complications which arose from time to time during the processing of individual leases, for example:

  (a) presence of structures with historical values within the site;

  (b) requirement to demolish structures or transplant trees erected over the Drainage Reserve Area;

  (c) requirement to protect highway structures and to build in appropriate lease clauses;

  (d) reservation of land stratum for new railway lines to pass through;

  (e) inclusion of slopes within lot boundaries for maintenance;

  (f) resolution of projecting structures from the lot over government land or private lot; and

  (g) resolution of encroachment over adjoining lot or vice versa; and

- such complications required additional negotiations with relevant government departments and parties, re-submission to the LandsD for approval and/or preparation of complex legal documentation.

55. Noting the difficulties encountered by the HA during the transfer of legal title, the Committee wondered why the HA had not sorted out the matter before the listing of The Link REIT. The Committee queried whether the HA was too rush to

sell its properties to The Link REIT without thoroughly considering all the implications.

56. The **Director of Housing** explained at the public hearing and in his letter of 24 May 2011 that the land on which most of the public housing estates were situated, including RC facilities within the estates, was vested in the HA by the Government under a vesting order. To complete the transfer of legal title of the divested properties to The Link REIT, it would first be necessary for the HA to obtain land leases from the Government and to enter into relevant DMCs for those properties. Owing to the large number of properties under the divestment portfolio, when The Link REIT was listed in November 2005, it was only possible to transfer to The Link REIT both the legal titles and beneficial ownership for 76 out of the 180 properties sold to The Link REIT. For the remaining 104 properties, only beneficial ownership was transferred at that time. Accordingly, agreements were entered into between the Government and the HA, and between the HA and The Link Properties Limited to provide for, inter alia, the transfer of legal title to the remaining properties to The Link REIT subsequent to its listing.

57. Given that The Link REIT could commence collecting rental charges for the 104 properties after the transfer of beneficial ownership in November 2005 but it was only required to pay government rent for such properties upon transfer of their legal title at a later stage (i.e. by mid-2008), the Committee queried if the Administration had taken effective measures to protect the interests of the Government and taxpayers. The Committee asked:

- whether the legal advisers engaged by the Administration had assessed and advised the Administration on the risks and potential financial implications of a delay in transferring the legal title of the divested properties from the perspective of the Government and taxpayers; and

- whether the overall valuation of the divested properties had reflected the financial implications of a possible loss of collectable government rent arising from the late completion of the title transfer process.

58. The **Director of Housing** replied at the public hearing and in his letter of 24 May 2011 that:

- the HA sought external legal advice for the divestment exercise. However, as far as the HD could determine, the policy bureaux and government departments involved relied upon the Government's own internal legal advisors for matters relevant to their particular interest;

- the Executive Council acknowledged that The Link REIT would only be charged government rent once the leases were completed. New leases of land were normally granted subject to payment of government rent. After the leases were granted and the legal title of the RC properties was transferred to The Link REIT, The Link REIT would need to pay government rent in respect of such RC properties. This was clearly explained in the LegCo Brief on "Divestment of HA's RC facilities" issued to the LegCo in July 2003; and

- the valuation of the RC properties covered was clearly intended to ensure that a fair market price was set for all of the properties in question. It was clear from the "Manager's Discussion and Analysis of Future Operations" section of the IPO Circular that The Link REIT would be required to pay government rent for List 1 properties upon divestment and that at a later stage for List 2 properties upon the issue of Government leases and the legal title of the RC properties being transferred to The Link REIT. This showed that this was a factor fully taken into account in the divestment exercise. Indeed, the fact that the leases would be put in place over a number of years following divestment was stated in the documents. The fact that the original intention to complete the exercise by the middle of 2008 was also clearly set out on page 93 of the IPO Circular.

59. In response to the Committee's further enquiries about the valuations of the RC properties sold to The Link REIT, the **Director of Housing** stated in his letter of 30 May 2011, in ***Appendix 24***, that the valuations of the divested RC facilities were carried out by an independent property valuer, CB Richard Ellis Limited. The aggregate market value of the divested properties as determined by the property valuer was $33.802 billion.

60. The Committee enquired whether the Administration had negotiated with The Link REIT for compensating the Government for not being able to charge government rent during the period from mid-2008 to July 2010 due to the late

completion of the transfer process. The **Director of Housing** said at the public hearing and in his letter of 24 May 2011 that:

- given the fact that the obligation to pay the government rent only arose when the Government lease concerned was granted, The Link REIT was not obliged to pay the government rent for those properties with no Government leases and the legal title to which had yet to be transferred to The Link REIT. There was thus no legal basis for the Government to recover from The Link REIT the alleged "notional" government rent chargeable in respect of the properties for the period during which the Government leases were yet to be granted; and

- The Link REIT paid a total lump sum which it was required to pay to the HA in 2005. It was fully understood that the transfer of legal title would be completed subsequently although the transfer took longer time than expected.

61. The Committee referred to paragraph 6.6(a) of the Audit Report, which stated that the HA would look for opportunities to divest the remaining RC facilities and those to be built in the future. However, paragraph 6.7 stated that in December 2009, the Secretary for Transport and Housing said that the HA had no plan to further divest its properties. The Committee asked:

- whether the change of policy was due to the negative comments by the general public on the divestment or obstacles which could not be dealt with; and

- whether the HA and the HD had conducted a post-implementation review on the whole divestment exercise, including the way to divest the properties and the valuation of the RC facilities.

62. The **Director of Housing** replied that:

- there were no particular obstacles to the divestment exercise. The HA had no plan to further divest its properties as it would be a good balance for the HA and the HD to retain some expertise in managing commercial properties. Moreover, the remaining properties were unpopular because of their poor location, small scale, old age or obsolescent conditions. It was anticipated that there would be very little interest for buying any of the remaining properties;

- the process of the 2005 divestment exercise was very transparent and the valuation was discussed in the community at that moment. The approach of the last divestment exercise was considered appropriate; and

- the HD would carry out a post-implementation review of the 2005 divestment exercise to consolidate the experience gained.

Role of the HA as the DMC manager

63. According to paragraphs 6.15 to 6.17 of the Audit Report, the HA has continued to act as the DMC manager for the divested RC facilities in 91 public housing estates. As the DMC manager, the HA is responsible for ensuring that The Link REIT complies with the DMCs and taking necessary measures to enforce the provisions of the DMCs. However, in September 2009, The Link REIT had not yet paid the management fees relating to the "common areas" in the majority of the housing estates for July and August 2009. In addition, LegCo Members had expressed concerns in September 2009 that many recreational facilities managed by The Link REIT had become dilapidated due to improper maintenance and urged the early re-opening of the facilities concerned.

64. The Committee asked about:

- the difficulties encountered by the HA in discharging its responsibilities as the DMC manager; and

- the amount of the outstanding management fees involved and why The Link REIT did not effect payment of the management fees.

65. The **Deputy Director (Estate Management)** said at the public hearing and the **Director of Housing** stated in his letter of 16 May 2011 that:

- the HD had been closely monitoring the work of The Link REIT to ensure its compliance with DMC and lease conditions. At present, except one recreational facility for which repairing works was still in progress, all recreational facilities concerned had been re-opened; and

- The Link REIT failed to effect payment of the management fees for July and August 2009 as there had been arguments on the amount of the management fees that it should pay, which was around $8 million. The

Link REIT had settled all the management fees in arrears in mid-September 2009.

E. Conclusions and recommendations

66. The Committee:

<u>Management of retail premises</u>

Day-to-day management of retail premises

- is surprised and regrets to note that the Housing Department ("HD")'s day-to-day management of the Hong Kong Housing Authority ("HA")'s retail premises is lax and ineffective, and the problems are attributable partly to the failure of staff of the HD and property management contractors to vigilantly follow the HD's set instructions and guidelines over the years, and partly to the HD management's failure to provide proper guidance to its staff (and contractor staff) on the conduct of inspection of retail premises and to deploy adequate manpower for the management of retail premises, as reflected by the following:

  (a) the HD had deployed only 16 senior managers to oversee the management of about 180 housing estates, which may not be adequate for effectively supervising HD frontline staff and contractors in properly carrying out the inspection of retail premises;

  (b) suspected gambling activities appear to be common occurrences in some retail premises. Although the HD issued an internal instruction in January 1997 requiring all estate housing managers to take various measures to deal with gambling activities, HD staff (and contractor staff) have failed to follow through the measures laid down in the instruction, as illustrated by the incidents mentioned in paragraph 2.14 of the Director of Audit's Report ("Audit Report");

  (c) although HD frontline staff (or security guards) are required to conduct daily patrols of retail premises to ensure the proper use and prompt maintenance of the premises, and to monitor tenants' performance under the marking scheme, and the HD has implemented a unit-to-unit inspection regime on all retail premises since July 2010, there are still cases of improper use and unauthorised alteration of retail premises (including storerooms);

(d) the HD's unit-to-unit inspection regime did not cover storerooms, and no guideline had been issued to HD staff (or contractor staff) to advise them to inspect the high-risk cases, such as repeated offenders and premises not regularly open for business, with a higher priority and frequency within the 18-month cycle period under the unit-to-unit inspection regime; and

(e) although a marking scheme has been implemented in HA retail premises since October 2006 and causing obstruction in public areas is one of the scheduled misdeeds under the scheme, the problem of obstruction in public areas is still common and some tenants repeatedly committed the misdeed. The Audit Commission ("Audit") found that there were instances of not allotting penalty points even after written warnings had been issued on the same misdeeds, and instances of not updating the records in the information system on marking scheme by HD staff and contractors after the issue of written warnings or allotment of penalty points;

- expresses concern that some let-out retail premises of HA retail facilities are not open for business (i.e. non-trading) during normal business hours. However, there is no provision in the HA's tenancy agreements that requires retail shops and cooked food stalls to open for business for any minimum hours per day or minimum days per week, and the "non-trading rule" in the HA's tenancy agreements for market stalls is less stringent than that stipulated by the Food and Environmental Hygiene Department ("FEHD"). The prevalence of non-trading retail premises is not conducive to achieving the HA's objective of enhancing residents' quality of life through the provision of retail, commercial and social facilities. There is also a risk that some premises, when not opened for business, might be used for purposes other than those specified in the tenancy agreements;

- acknowledges that:

(a) the HD has investigated into individual suspected cases identified by Audit and taken tenancy enforcement actions where appropriate;

(b) the HD has issued a new internal instruction to provide detailed guidelines advising HD/contractor staff to step up the unit-to-unit inspections according to the prescribed priority and the frequency based on the high-risk categories such as repeated offenders and non-trading retail premises;

(c) the HD will report all suspected gambling activities to the police and, in case of conviction, take tenancy enforcement actions including issuance of notice-to-quit;

(d) the HD will review the feasibility to specify opening hours in tenancy agreements appropriate to the nature of business and customer demand in respect of the retail facilities, having regard to the best interest of the domestic tenants; and

(e) the Director of Housing has agreed with the audit recommendations in paragraph 2.20 of the Audit Report;

- urges the Director of Housing to:

(a) review the adequacy of manpower deployed for overseeing the management of retail premises, so as to effectively supervise HD frontline staff and contractors in properly carrying out the inspection of retail premises, and strengthen the manpower where appropriate;

(b) take measures to ensure that HD staff and contractors will strictly follow through the measures set out in the internal instruction of January 1997 to deal with gambling activities;

(c) consider modifying the existing marking scheme to cover improper and unauthorised use of retail premises, such as gambling; and

(d) take prompt action to tighten the "non-trading rule" for HA market stalls, having regard to the FEHD's practice;

Letting of retail premises and implementation of improvement measures

- regrets that many HA retail premises have remained vacant for a long time. Of the 251 vacant retail premises which were available for letting as at December 2010, 122 (49%) had been vacant for over three years. Although the HD has taken improvement measures in recent years in some markets, their effectiveness is yet to be seen as the market vacancy rates have remained high;

- recognises that the long vacant retail premises are often located in older public housing estates and unpopular locations, but regrets that the HD had taken neither effective measures to let out those retail shops nor prompt actions to explore viable options to optimise their use, leading to a waste of public resources, as follows:

  (a) the HD had not taken adequate measures to ensure that these vacant premises are widely publicised and put up for open tender as frequently as practicable;

  (b) for vacant premises which did not attract any bidder in an open tender, the HD would normally take quite a long time (about two calendar months) to re-tender the same premises. As a result, if an open tender for letting out a retail premises is unsuccessful, the same premises will remain vacant for at least another two months before procedures for re-tendering could be completed;

  (c) a vacant retail shop in Wah Fu (II) Estate had been repeatedly re-designated for different trades, some of which were very similar, based on the HD staff's own knowledge and experience in over 25 unsuccessful re-tendering exercises since 2004. This reflects that the HD staff concerned had only conducted the re-tendering exercises as a matter of routine without analysing the reasons why the shop had not attracted any bidders, so as to identify effective ways to let out the shop, and market research had not been conducted to ascertain the latest retail trend and actual demand for the vacant shop; and

  (d) the factors taken into account by the HD in setting the priority for major improvement works do not include vacancy rates of the retail facilities concerned;

- acknowledges that:

  (a) the HD has taken initiatives to optimise the use of surplus retail facilities and reduce vacancy rates through conversion to other uses to suit residents' need, and market re-ordering exercise;

(b) the HD has, as approved by the Commercial Properties Committee ("CPC"), earmarked the retail facilities at Wah Fu (II) Estate for early consideration of major improvement works to enhance their commercial potential; and

(c) the Director of Housing has agreed with the audit recommendations in paragraphs 2.30 and 2.40 of the Audit Report;

- urges the Director of Housing to:

(a) conduct market research to ascertain the actual demand for long vacant retail premises, and proactively explore options to optimise the use of the premises having regard to the actual demand, e.g. letting out the premises to welfare organisations/arts groups, or converting them to other gainful uses such as library or students' study room; and

(b) expeditiously carry out major improvement works for the retail facilities at Wah Fu (II) Estate to enhance their commercial potential;

Monitoring of operating expenditure

- expresses concern that in 2009-2010, the operating expenditure for many retail facilities exceeded the HD's benchmarks. Some estate housing managers had not fully reported the non-compliance to the senior management, nor had they proposed adequate follow-up action to control the expenditure;

- acknowledges that:

(a) the HD will conduct periodic reviews on operating expenditure, and has provided specific training courses to local management staff on accounting guidelines and charging principles for business accounts; and

(b) the Director of Housing has agreed with the audit recommendations in paragraph 2.48 of the Audit Report;

- urges the Director of Housing to implement the above audit recommendations expeditiously;

Management of car parks

- expresses concern that:

  (a) the provision of public housing carpark facilities had turned out to be greater than the actual demand for many aged estates. This has led to surplus provision of parking spaces and high vacancy rates in these HA car parks, resulting in under-utilisation of valuable resources;

  (b) despite the HD's efforts in recent years to improve the utilisation of car parks, in December 2010, 46 (39%) of the 117 HA car parks still had a low occupancy rate of below 70%;

  (c) for Project 3 relating to leasing part of a car park to Organisation C for operating a telephone transaction centre cum volunteers and training centre, although it was a commercial letting according to HD records, the rent charged was on a par with the concessionary rent normally applicable for welfare lettings. This was contrary to the HD's established practice of charging market rent for commercial lettings;

  (d) although the HD had informed the HA's CPC that conversion works for Project 3 would commence only after Organisation C had signed and accepted the HA's letter of offer, the HD started the works more than two months before the signing of the letter of offer; and

  (e) although the HD's internal instruction stipulates that a tenant is not allowed to move into the premises unless the tenancy agreement has been executed, the HD started to hand over the premises to Organisation C more than two years before its signing of the tenancy agreement;

- acknowledges that:

  (a) substantial revisions to the parking standards for public housing developments have been made since 2009. The HD has, in consultation with the Transport Department, refined the planning standards of parking spaces, and will continue to carefully plan the provision of parking facilities appropriate to new public housing developments on a case-by-case basis;

(b) while a five-year programme for carpark improvement will be rolled out, the HD will implement short-term measures such as change of use of parking spaces (e.g. change from private car to motorcycle parking spaces) and letting to non-residents to improve occupancy rates;

(c) the Director of Housing considered that Project 3 was a very special case. The HD will continue the practice of making rent assessment for other major conversion projects;

(d) the Director of Housing has agreed with the audit recommendations in paragraphs 3.12, 3.21 and 3.34 of the Audit Report; and

(e) the Commissioner for Transport has agreed with the audit recommendation in paragraph 3.12 of the Audit Report;

- urges the Director of Housing to take effective actions to implement the above audit recommendations;

<u>Management of factory estates</u>

- is disappointed that:

(a) the HD had not formulated an effective strategy to implement the HA's 1989 policy of absolving itself from the ownership and management of factory estates in the long term during the past 21 years, and it was only after the matter was raised by Audit that the HD sought the CPC's approval in April 2011 to modify the HA's policy whereby the HD would continue managing the six newer factory estates *pro tem* and review the situation from time to time; and

(b) the HD's procedures for detecting subletting or unauthorised use of factory premises were not properly followed in the two factory estates visited by Audit, and there were cases of unauthorised subletting of factory premises;

- acknowledges that:

(a) in March 2011, the CPC approved a plan to clear the Chai Wan Factory Estate. The HA considers that the site is suitable for public rental housing development and intends to seek its allocation for that purpose;

(b) the Director of Housing has undertaken to inform the Legislative Council ("LegCo") if there is a substantial change to the long-term policy on the ownership and management of the six newer factory estates in future;

(c) the HD has investigated into each suspected subletting case and taken necessary actions to rectify the problem; and

(d) the Director of Housing has agreed with the audit recommendations in paragraphs 4.11, 4.16 and 4.28 of the Audit Report;

- urges the Director of Housing to promptly inform the LegCo if there is a further change to the policy on the ownership and management of the six newer factory estates;

Performance measurement and reporting

- expresses concern that:

(a) the HD had not properly calculated the vacancy rates of retail premises for reporting to the CPC, as detailed in paragraphs 5.5 to 5.7 of the Audit Report;

(b) the HD did not systematically collect feedback on the residents' satisfaction level on performance in various aspects of the management of commercial properties; and

(c) apart from retail premises, there are no key performance indicators ("KPIs")/targets to measure the vacancy position of other types of properties (i.e. car parks, factory estates and welfare premises);

- acknowledges that:

(a) the HD will exclude all new premises, which are not yet ready for letting, from the total stock in calculating the vacancy rates, and will revisit the approach in reporting the vacancy rate of different categories of non-domestic premises;

(b) the HD will extend the scope of its annual Public Housing Recurrent Survey to cover residents' satisfaction level on management of HA commercial properties, and closely monitor the survey findings for benchmarking purpose;

(c) the HD will consider the audit recommendation of setting specific KPIs and targets (e.g. vacancy rate) for different types of commercial properties in the forthcoming 2012-2013 business plan for commercial properties; and

(d) the Director of Housing has agreed with the audit recommendations in paragraph 5.12 of the Audit Report;

- urges the Director of Housing to implement the above audit recommendations without delay;

<u>The way forward</u>

- notes that:

(a) one of the reasons for the divestment of the HA's retail and carpark facilities was that with the cessation of construction and sale of Home Ownership Scheme flats, the HA lacked a recurrent source of income. Proceeds from the divestment would help the HA meet its funding requirements in the short term; and

(b) at the time when The Link Real Estate Investment Trust ("The Link REIT") was listed in 2005, the HA could only transfer to it the legal title of 76 divested properties;

- regrets that:

(a) although it was intended that the legal title of the remaining 104 divested properties would be transferred to The Link REIT in batches by mid-2008, there were 54 divested properties the legal title of which could only be transferred to The Link REIT after mid-2008. The late completion of the transfer had deprived the Government of the right to charge government rent on the divested properties during the period from mid-2008 to July 2010, resulting in a loss amounted to some $30 million;

(b) the Administration had not before the listing of The Link REIT conducted a comprehensive risk assessment, from the perspective of the Government and the taxpayers, of the delay in transfer of legal title and take effective measures to protect the Government from the loss of collectable rent. For example, although the Administration was fully aware that The Link REIT would only be required to pay government rent for the 104 properties upon transfer of their legal title at a later stage (i.e. by mid-2008), it failed to make alternative arrangements to cater for a delay in completing the transfer, such as by requiring The Link REIT to make a lump sum payment or periodical payments for the properties concerned to cover the government rent for the period before completion of the transfer. Besides, the Panel on Housing of the LegCo had not been apprised of the possible loss of government income due to the delay in completing the transfer of the legal title of the properties; and

(c) various issues have arisen from the 2005 divestment exercise, as detailed in paragraphs 6.8 to 6.20 of the Audit Report. However, the HA has not conducted a post-implementation review to consolidate the experience gained from the divestment exercise;

- acknowledges that:

  (a) although the HA has no plan to further divest its retail and carpark facilities at this stage, it will conduct a post-implementation review of the 2005 divestment exercise;

  (b) the Director of Housing has agreed with the audit recommendations in paragraph 6.26 of the Audit Report; and

  (c) the Secretary for Financial Services and the Treasury has agreed with the audit recommendations in paragraph 6.26(c) and (d) of the Audit Report;

- urges the Administration and the HA to learn the lessons from the 2005 divestment exercise and critically assess all the financial implications of any delay in transferring the legal title of the divested properties and make alternative arrangements to safeguard the Government's income, when planning a divestment exercise in the future;

- urges the Director of Housing to conduct a post-implementation review of the 2005 divestment exercise expeditiously and inform the LegCo of the outcome of the review; and

Follow-up action

- wishes to be kept informed of the progress made in implementing the various recommendations made by the Committee and Audit.