# Legislative Council
# Panel on Economic Development

## Expansion and Development Plan of Hong Kong Disneyland Resort

*The Government's response to matters arising from the Panel meetings on 28 November 2016 and 13 December 2016*

## PURPOSE

This paper sets out the Government's response to –

(i) the three motions passed at the Panel meetings on 28 November 2016 and 13 December 2016 regarding the expansion and development plan of the Hong Kong Disneyland Resort ("the Plan") (at **Annex A**); and

(ii) the list of follow-up actions arising from the Panel meeting on 28 November 2016 (at **Annex B**).

## RESPONSE TO THE THREE MOTIONS PASSED

2. At the Panel meetings on 28 November 2016 and 13 December 2016, three motions regarding the Plan (see **Annex A**) were passed. In the light of the discussion at the Panel meeting on 28 November 2016 and the said three motions, the Government has further discussed the details regarding the Plan with The Walt Disney Company ("TWDC"). To pay due regard, and to respond positively to Panel members' views, the Government and TWDC will give further thoughts to the overall arrangements for taking forward the Plan.

### *Details*

*Financial investment by the Government and TWDC*

3. Hong Kong Disneyland Resort ("HKDL") is an important and strategic tourism infrastructure of Hong Kong, and its development has to tie in with the Government's policy to promote tourism industry and overall economic development. Given HKDL's strength in attracting high-value added visitors from all over the world and lengthening their stay in Hong Kong, it has been bringing significant economic benefits and employment opportunities to hotel and other tourism-related trades, as well as retail, food and beverage sectors.

4. While the financial investment in the Hongkong International Theme Parks Limited ("HKITP")[1] by the Government has been higher than that by TWDC, the difference has been narrowing down over the years. Under the agreement between the Government and TWDC reached in 1999 when the Hong Kong economy was hard hit by the Asian financial crisis, the Government initially invested $3.25 billion as cash equity and $6.10 billion as loan to HKITP, and TWDC provided cash equity of $2.45 billion. That notwithstanding, in the past 11 years of HKDL's operation, the Government has not made new capital injection to HKITP, and only converted its existing loan into equity to maintain the majority shareholder status and provided a new loan of about $800 million for the third hotel development agreed in 2014. During the same period, TWDC has invested a total of some $8.2 billion in HKITP, which is more than ten times of the investment by the Government, by way of cash equity injection and loan under the expansion plan for three new themed areas agreed in 2009 and the said third hotel development.

5. As a result, the level of financial investment in HKITP by the Government and TWDC is getting more balanced throughout the operation of HKDL. It is projected that by the end of Fiscal Year 2017 ("FY17"), total financial investment (in terms of equity and loan) in HKITP by the Government would be $11.85 billion (holding 53% of HKITP's equity), while that by TWDC would be $10.65 billion (holding 47% of HKITP's equity), and the difference in total financial investment (in terms of equity and loan) would be $1.20 billion only.

6. The above development demonstrates TWDC's strong commitment in the HKDL project. TWDC is prepared to invest in HKDL continuously to make the resort a success.

*Project cost breakdown*

7. In response to some Panel members' request for more details of the project cost, a more detailed breakdown of the project estimate is at **Annex C**. We wish to point out that over 90% of the project cost of $10.90 billion would be spent on local operations or construction works/materials by third-party companies not related to TWDC. Any fees to be paid to TWDC's related companies for the design and technology development would be charged on cost recovery basis.

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[1] The joint venture set up by the Government and TWDC for the development and operation of the HKDL project.

*Royalties and management fees*

8. Payment of royalties and management fees to TWDC is common to Disney resorts outside the United States in general. For royalties, TWDC charges all Disney resorts outside the United States for the access to and use of Disney's intellectual properties for the resorts' development and operation. Based on publicly released information, the royalty rate charged by TWDC on Disney resorts outside the United States is largely the same at 5% to 10% of revenues, depending on the source of revenues (e.g. merchandise, food and beverage, admission, etc.). Having regard to the industry practice, TWDC advises that its royalty rate is in-line with the comparables in the media and entertainment sector[2].

9. As regards management fees paid by Disney resorts outside the United States, the exact calculation mechanism varies across different resorts. For Disneyland Paris, the base management fees are charged at 1% to 6% of revenues, while the variable management fees are calculated based on 30% of pre-tax adjusted cash flow, in excess of 10% of gross fixed assets. As for Shanghai Disney Resort, its management fee mechanism was designed with reference to HKDL's arrangements before the improvement agreed in 2009 as elaborated in paragraph 10 below.

10. Since 2009, HKDL's management fees are fully linked to the resort's performance (i.e. earnings before interest, tax, depreciation and amortisation ("EBITDA")), which is an improvement over the arrangement based on revenues as agreed in 1999 and can better incentivise the management company (i.e. the Hong Kong Disneyland Management Limited) to drive the business performance and operational efficiency of HKDL. According to the arrangements between the Government and TWDC in 2009, the formula for calculating the base management fee is adjusted to 6.5% of EBITDA, instead of the original formula of 2% of gross revenues, and the formula for calculating the variable management fee is adjusted from 2% to 8% of EBITDA to 0% to 8% of EBITDA. Under normal operations of Disney resorts, compared with the cases of Paris and Shanghai resorts as well as Hong Kong's arrangements before the improvement in 2009 where the management fees are tied to revenues, linking management fees to EBITDA could better align the fees with the resort's financial interest. Indeed, since the implementation of the improved management fee arrangements in 2009, HKITP has recorded positive EBITDA for seven consecutive years between FY10 and FY16. This shows that the current arrangements have struck a right balance in providing incentives for the management company to enhance HKITP's financial performance, while at the

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[2] For royalty rates in the media and entertainment industry, the median was 8% based on the market financial data up to 2000 (Russell Parr. *Royalty Rates for Licensing Intellectual Property*. Hoboken: John Wiley & Sons, Inc., 2007.).

same time not being inferior to the management fee arrangements for other Disney resorts outside the United States.

11. Notwithstanding the above, we have further discussed this issue with TWDC in the light of Panel members' comments. TWDC is prepared to give due consideration to Panel members' views in considering flexibility in the management fee arrangements.

*Relaxations to development restrictions*

12. TWDC believes that HKDL, being part of Lantau, stands ready to benefit from the overall planning and development of the area which would bring new business opportunities to HKDL. TWDC has been and will continue to be supportive of the developments in the Lantau area. Having regard to Panel members' concerns over the existing development restrictions in the peripheral areas of HKDL and in order to facilitate the Government's potential developments around the Lantau area, TWDC would examine positively in this regard.

## RESPONSE TO THE LIST OF FOLLOW-UP ACTIONS

*(a) Sensitivity analysis of the economic assessment of the Plan; and*
*(b) Assumptions of the economic assessments conducted in 1999, 2009 and 2016*

13. The Government conducted economic assessments for the HKDL project on three occasions, namely, in 1999 (before the construction of HKDL), 2009 (when the expansion plan for three new themed areas was considered) and 2016 (in the context of considering the Plan). Details of the methodology are set out in the Government's paper for the Panel meeting on 28 November 2016 (*Annex D to LC Paper No. CB(4)154/16-17(02)*). Major assumptions of the three economic assessments are summarised in the table below.

**Table 1: Major assumptions of economic assessments for the HKDL project**

| | **1999 assessment** | **2009 assessment** | **2016 assessment** |
|---|---|---|---|
| **Share in total attendance / incremental attendance of HKDL** | | | |
| - Base tourists+ | 40% – 44% | 50% – 58% | 37% |
| - Induced tourists+ | 24% – 30% | 16% – 23% | 31% |
| - Locals+ | 28% – 34% | 23% – 27% | 31% |
| **Length of stay in Hong Kong** | | | |
| - Additional length of stay of base tourists | 0.2 – 0.5 night | 0.7 night | 0.6 night |
| - Length of stay of induced tourists# | 2.9 – 3.1 nights | 2.7 – 2.8 nights | 2.8 – 3.0 nights |

| | 1999 assessment | 2009 assessment | 2016 assessment |
|---|---|---|---|
| **Average daily spending of tourists *($ in 2014 prices)*** | | | |
| - Base tourists | 2,700^ | 2,000 | 2,400 |
| - Induced tourists# | 2,300^ | 1,700 – 2,200 | 1,600 – 2,500 |
| **Average spending of local visitors *($ in 2014 prices)*** | 600 – 700^ | 300 | 300 |
| **Crowding-out effect on spending by local visitors*** | 0% – 60% | 50% | 50% |

*Notes:*
+ *Figures for the 1999 and 2009 assessments refer to the distribution of total attendance, while figures for the 2016 assessment refer to the distribution of incremental attendance.*
# *There is a slight variation for induced tourists from different markets.*
^ *Adjusted to 2014 prices, and thus different from the figures published in 1999.*
* *This refers to the extent of reduction in consumption spending on items not related to HKDL, in terms of percentage of additional spending due to HKDL.*

14. For the economic assessment of the Plan conducted in 2016, the Government has provided the assessment results under two different situations, namely Situation A and Situation B, and the former is a more conservative situation compared with the latter. Our economic assessment of the Plan also takes into account a sensitivity test for the more conservative Situation A by reducing TWDC's projected incremental visitors to HKDL brought by the Plan by 15%. The results of this sensitivity test, as shown in the table below, indicate that even under very prudent assumptions, the Plan is still likely to bring about considerable net benefits to the economy.

**<u>Table 2: Summary of economic assessment of the Plan</u>**

| | Total gross economic benefits ($2014 prices in present value) | | Total net economic benefits ($2014 prices in present value) | | Economic internal rate of return in real terms | | Benefit/cost ratio in present value terms | | Breakeven year @ |
|---|---|---|---|---|---|---|---|---|---|
| | Over the operation period of | | Over the operation period of | | Over the operation period of | | Over the operation period of | | |
| | 20 years | 40 years | 20 years | 40 years | 20 years | 40 years | 20 years | 40 years | |
| Situation A | 24.7 bn | 45.8 bn | 17.7 bn | 38.5 bn | 23.2% | 24.3% | 3.5 | 6.3 | FY25 |
| Situation B | 27.0 bn | 50.2 bn | 18.7 bn | 41.6 bn | 22.9% | 24.1% | 3.2 | 5.8 | FY25 |
| **Sensitivity test** | 21.0 bn | 38.9 bn | 14.0 bn | 31.6 bn | 20.1% | 21.5% | 3.0 | 5.3 | FY26 |

*Notes:*
@ *"Breakeven year" refers to the year when the present value of the cumulative gross economic benefits just offset the cumulative economic cost.*

### *(c) Methodology for deriving the financial internal rate of return*

15. Financial internal rate of return indicates the discount rate at which the future cash flow of an investment breaks even, i.e. the net present value of costs of the investment equal to the net present value of the benefits of the investment.

A positive rate of return indicates that the investment would generate net positive cash flow and that a higher rate indicates a better investment. This is in line with the calculation of commercial investment projects.

16. In considering the financial return of the Plan, the internal rate of return, estimated at over 5% in real terms, is calculated based on the net cash flow in present value arising from the revenues generated from, and additional costs (e.g. capital and operating expenditure) brought about by, the Plan. We consider that this level of return reasonable.

*(d) Considerations of the Government to maintain the majority shareholding status in HKITP*

17. Paragraph 4 above explains the historical background of the higher initial financial investment in HKITP by the Government when the agreement was reached in 1999 during which the economy of Hong Kong was hard hit by the Asian financial crisis. In the past 11 years of HKDL's operation, the Government has only converted its existing loan into equity to maintain the majority shareholder status and provided a new loan of about $800 million for the third hotel development agreed in 2014. During the same period, TWDC has invested a total of some $8.2 billion in HKITP, which is more than ten times of the investment by the Government, and it remains a matter of fact that the Government has maintained as a majority shareholder of HKITP. We consider it conducive to our monitoring of HKDL, as an important tourism infrastructure, to ensure that the direction and pace of HKDL's development (such as mode, scale, cadence, timetable and positioning) will tie in with the sustainable development of our tourism industry towards diversified and high value-added services in the light of our tourism performance. Same as other Government's investments, we will continue to keep in view our investment position in HKITP and monitor its overall performance on an on-going basis.

*(e) Features of the agreement between the Government and TWDC vis-à-vis similar Disneyland projects outside the United States; and*
*(f) Terms of calculating royalties and management fees*

18. Each of the Disney resorts outside the United States has its own unique partnership arrangements with TWDC which are different from one another. The gist is summarised in the ensuing paragraphs.

19. For Disneyland Paris and Shanghai Disney Resort, some forms of government participation as well as TWDC's ownership are involved in the projects. Specifically, the French government does not hold any stake in Disneyland Paris. At the initial development stage, the French government sold the land for Disneyland Paris (formerly known as Euro Disney Resort) at farmland prices to TWDC. It also provided financial incentives, including loan

of about US$770 million at lower-than-market interest rate and cash grant of about US$30 million, as well as basic infrastructure support, including financing subway and motorways, arranging trains to stop at the resort's entrance and arranging direct link with traffic from Euro-tunnel. Moreover, the French government offered tax concessions to the resort.

20. As for Shanghai Disney Resort, the Shanghai government holds 57% ownership of the joint venture (i.e. about RMB 13 billion equity). The Shanghai government built and financed the basic infrastructure in the vicinity. In addition, the Shanghai government provided loan and revolving credit facility to the Shanghai resort (about RMB 8 billion financial commitment in total). The land for Shanghai Disney Resort is state-owned and rented to the joint venture of the resort.

21. Tokyo Disney Resort is a commercial partnership deal. The Tokyo resort is wholly owned by a private company, Oriental Land Co., Ltd. ("OLC"), without any ownership by TWDC, and is built on the land owned by OLC.

22. The Government of the Hong Kong Special Administrative Region currently owns 53% of the equity of HKITP (i.e. about $10.7 billion equity). Similar to the cases of Disneyland Paris and Shanghai Disney Resort, the Government provided the infrastructure in the vicinity of HKDL as well as some loans (currently about $1.15 billion in total) to HKITP. The land premium for the Phase 1 site of HKDL was paid in the form of $4 billion subordinated shares of HKITP which would be converted to ordinary shares progressively throughout the life of the project subject to operating performance.

23. It should be noted that each Disney resort outside the United States has its own unique development history and specific circumstances, and due regard should be given to these specific factors in making comparison among them. Nonetheless, as seen from the above, the partnership arrangements with TWDC for HKDL have some similarities to those for other Disney resorts outside the United States in terms of capital structure and infrastructure provision, and there is no indication that the partnership arrangements for HKDL are inferior to the Disney resorts at other sites.

24. On the arrangements of royalties and management fees in different Disney resorts outside the United States, please refer to paragraphs 8 to 10 above.

*(g) Progress of the discussion with TWDC on relaxing the height restrictions of development in the vicinity of HKDL*

25. Please refer to paragraph 12 above.

## WAY FORWARD

26. Members are invited to note the Government's response as set out in this paper to Panel members' views expressed and the three motions passed regarding the Plan and the HKDL project as a whole. We aim to seek the Finance Committee's approval to the financial arrangements for the Plan as soon as possible.

**Tourism Commission**
**Commerce and Economic Development Bureau**
**February 2017**

**<u>Annex A</u>**

**Motions passed at Panel on Economic Development meetings on 28 November 2016 and 13 December 2016 regarding "Expansion and development plan of Hong Kong Disneyland Resort"**

**Motion moved by : Hon LUK Chung-hung**
**Motion seconded by : Hon YIU Si-wing, BBS**

That this Panel urges the Government, while promoting the expansion of Hong Kong Disneyland Resort, to set up a fund for the development of tourism with local features, which can step up the promotion of the culture, history and nature tours of Hong Kong, enrich the tourism experience for our visitors and encourage more visitors to visit Hong Kong, so as to boost employment, provide more training opportunities and contribute to the economic development.

**Motion moved by : Hon Michael TIEN Puk-sun, BBS, JP**

That this Panel requests the Government to defer the Hong Kong Disneyland expansion plan, given that the Government and The Walt Disney Company ("TWDC") cannot provide further details of the agreement due to its confidential character, and that the Government has not negotiated with TWDC to improve the unfair terms and conditions in the agreement, including but not limited to the calculation of management fees and consultants' fees.

**Motion moved by : Hon Holden CHOW Ho-ding**
**Motion seconded by : Hon LEUNG Che-cheung, BBS, MH, JP**

That this Panel requests that the Government and The Hong Kong Disneyland Management Limited ("HKDML") publish more information and data before submitting a funding application for the new expansion project, so as to address the queries raised in the community about the project; at the same time, the Government has to review and seeks to amend the current operating terms which are too favourable to The Walt Disney Company, including but not limited to the income earned by the Hong Kong Disneyland Resort ("HKDL") from royalties and others, as well as to relax development restrictions in the vicinity of HKDL (including Lantau Island), so as to safeguard the investment of public funds and the overall development of Hong Kong.

**<u>Annex B</u>**

**List of follow-up actions arising from the discussions on "Expansion and development plan of Hong Kong Disneyland Resort" at Panel on Economic Development meeting on 28 November 2016**

At the Panel meeting on 28 November 2016, the Government was requested to provide information on –

(a) given that the economic assessment of the proposed expansion and development plan of Hong Kong Disneyland Resort ("HKDL") was based on the attendance forecast provided by The Walt Disney Company ("TWDC"), the impact if such forecast cannot be achieved as well as details of the relevant sensitivity analysis of the project;

(b) comparison of the economic assessments conducted for the development/expansion plans of HKDL in 1999, 2009 and 2016 respectively in tabular format, covering major assumptions adopted;

(c) details of the methodology and formula used for deriving the financial internal return rate of the Government's investment in the proposed expansion and development plan of HKDL;

(d) considerations of the Government to maintain its majority shareholding status in the Hongkong International Theme Parks Limited;

(e) comparison of the major features of the agreement between the Government and TWDC for the proposed expansion and development plan of HKDL vis-à-vis similar Disneyland projects overseas;

(f) whether the Government will negotiate with TWDC for more favourable terms in the calculation of payment for management fees, consultant's fees and royalties so that such fees would be paid to TWDC only when HKDL makes a net profit in that year; and

(g) progress of the discussion with TWDC on relaxing the height restrictions of development in the vicinity of HKDL under the agreement reached between the Government and TWDC in 1999.

**Annex C**

**Detailed breakdown of project cost estimates for expansion and development plan of Hong Kong Disneyland Resort**

| Item | Sub-item | Cost estimates ($ billion) |
|---|---|---|
| Facility | ➢ Site development<br>➢ Area development<br>➢ Facility construction (including buildings, structures, landscape and other related works)<br>➢ Construction preliminaries (including site surveying, ground investigation, various assessment and other related items) | 0.5<br>0.4<br>2.7<br><br>0.7 |
| ***Sub-total*** | | **4.3** |
| Show | ➢ Show and stage construction and management<br>➢ Show and stage production (including media, audio/visual systems, special effects, props, show sets, etc.)<br>➢ Mechanical and electrical engineering works, as well as installations of various facilities related to show and stage | 0.3<br>1.6<br><br><br>0.3 |
| ***Sub-total*** | | **2.2** |
| Ride | ➢ Works and installation of ride (including ride vehicles and tracks, security, surveillance control systems, as well as support and electrical systems)<br>➢ Purchase of ride and relevant security/surveillance control systems, as well as support and electrical systems | 0.3<br><br><br>0.7 |
| ***Sub-total*** | | **1.0** |
| Design and management costs | ➢ Design and creative work<br>➢ Project management/construction management/field costs of construction works<br>➢ Operational requirements | 1.1<br>0.9<br><br>0.1 |
| ***Sub-total*** | | **2.1** |
| Creative entertainment | ➢ Entertainment shows (including stage shows, meet-and-greet with Disney characters, and atmosphere entertainment programme)<br>➢ Production and installation of the above items | 0.1<br><br><br>0.4 |
| ***Sub-total*** | | **0.5** |
| Contingency reserve | | **0.8** |
| **Total** | | **10.9** |