

Memo

To: Mr. Vincent Chua
Director, Discovery Bay Services Management Limited

Date: 10th February, 2014

Re: Follow-up: Date of First Charge for City Expenses under the DMC.

Dear Vincent,

I write to set down for the record my serious misgivings regarding Discovery Bay Services Management Limited's ("City Management (CM)"; the "Manager"; "your Company") handling of my memo dated 11th July, 2011: "Date of First Charge for City Expenses under the DMC".

As you will recall, your Company referred my memo of 11th July, 2011, to your legal advisor, JSM. CM then sent a copy of JSM's reply of 24th October, 2011, to members of the City Owners' Committee ("COC") and the Finance Subcommittee of the COC on 26th October, 2011. CM has called this letter from JSM "legal advice". In my rebuttal dated 9th January, 2012, I pointed out that the JSM letter largely consisted of references to statements made by CM. I consider it highly misleading and inappropriate for CM to characterise as "legal advice" a letter that merely repeats your Company's own statements.

Your Company should have been more sensitive to the context when responding to my memo. Hong Kong Resort Co Ltd ("HKR", the "Registered Owner"), is a connected person of your Company. The Date of First Charge for City Expenses involves the interests of HKR, and you should at all times be mindful of your fiduciary duty to all Owners of Discovery Bay, and the obligations of HKR under the Law and under the Listing Rules.

Review of the DMC

Allow me to review once again what the DMC says about responsibility for contributing to the City Expenses: (All paragraphs in italics are quoted from the DMC. Bold emphasis is added.)

Section IV. Management of the City

D. Management Expenses (Page 26)

1. For the purpose of fixing the contributions payable by the Owners of the City and each Village, the Manager shall prepare :-

(a) an annual budget showing the estimated expenditure **in respect of each Village** other than the car parks therein;

(b) an annual budget showing the net estimated expenditure **in respect of the City** other than the car parks therein;

after taking into account estimated receipts towards the Management Funds other than in regard to car parks therein as provided by these presents.

Thus, the Manager is required to prepare two separate budgets each year, one in respect of the expenditure for each Village and one in respect of the expenditure for the City. For information, "the Owners" is defined in the DMC to include HKR (Page 4).

Paragraph 7(a) (Page 29) requires that Management Units (MU) be allocated to each Residential and Commercial Unit as soon as such Unit is “completed and developed”.

7. (a) Management Units will be allocated to all Residential and Commercial Units according to the GBA of each such unit as soon as the same [is] completed and developed.

(b) Management Units will also be allocated to the Clubs according to the GBA of each club house building as soon as it is completed and developed (excluding the grounds connected to the Clubs) and in the event the Club house buildings shall be extended or reduced, the number of Management Units allocated as aforesaid shall similarly be increased or reduced.

(c) So long as any part or parts of the City is or are undeveloped for any reason whatsoever, that part or parts of the City shall not be allocated any Management Units until the same is completed and developed.

"Developed or Completed Structure" is defined in the DMC. A structure is developed or completed upon the issue of the Occupation Permit (Page 6). Thus, MU are allocated to the Units in any Village or future Village upon the issue of the Occupation Permit. The allocation of MU to the Residential Units may occur before the formal creation of the Village.

Paragraph 9 (Page 29) explicitly links allocation of management expenses and MU to the issue of the Occupation Permit. In fixing the amount of City Expenses due to be paid by each Owner, CM must include all MU of all the Villages – or parts thereof – for which an Occupation Permit has been issued in the financial year in question – or any part thereof. CM has no discretion to exclude any MU. The portion of total City Expenses due from any Village is the ratio of that Village's MU to the total MU.

9. The management expenses of the City shall be allocated to each Village in the ratio produced when the sum of the Management Units allocated to each Village is divided by the sum of the Management Units of all the Villages or parts thereof for which an occupation permit has been issued in the financial year in question or any part thereof.

While a Village only comes into being upon the execution of a sub-DMC (definition of Village on Page 1 of the DMC), management expenses accrue from the issue of the Occupation Permit.

H. Management Records and Accounts (Page 34)

1. The financial year for the purpose of management of any particular Village shall commence on the day on which the Occupation Permit of the first completed Residential Unit or Commercial Unit or Other Unit in that particular Village is issued and shall terminate on the 31st day of December of the following year but thereafter the financial year shall commence on the 1st day of January and shall terminate on the 31st day of December of that year Provided Always that the Manager shall have the right to change the financial year at any time upon giving notice in writing to the Owners.

This paragraph makes it clear that the first financial year of a Village commences on the day on which the Occupation Permit of the first completed Residential, Commercial or Other Unit in that particular Village is issued. It does not matter that the Sub-Deed of Mutual Covenant for that Village has not come into force as of the date of the issue of the Occupation Permit –

the first financial year of a Village always commences from the date of the first Occupation Permit.

Lastly, the Manager has an obligation to provide management services from the date of the issue of an Occupation Permit. The requirement, as stipulated at Paragraph A(4), Page 18, is not linked to the formal creation of a Village through the execution of a Sub-DMC:

4. The obligations of the Manager to provide management in respect of any part of the City shall commence from the date when an Occupation Permit has been issued in respect of such part.

It stands to reason that, if services are provided from the date of the issue of an Occupation Permit, the services are paid for from that date.

For completeness, the definition of City is: "The whole of the development on the Lot to be known as "DISCOVERY BAY CITY" (偷景灣) including all the buildings therein." (Page 1)

The "standard criteria" described in the JSM letter

It is plainly evident that the obligation to share the cost of the City Expenses begins on the date of the issue of the Occupation Permit:

- MU are allocated to the relevant Units on that date.
- MU are counted for the purpose of fixing contributions to the Management Expenses of the City from that date.
- The first accounting period of a Village commences on that date.
- The Manager has the obligation to provide management services from that date.

Contrary to the claims made in the JSM letter, the obligation to share the cost of City Expenses does not begin – in respect of Residential Units – "when the first purchaser of a Unit in a Village is expected to take possession of his Unit"; nor does it begin – in respect of Commercial Units – "when the first Unit in the relevant phase is expected to be capable of being practically occupied for beneficial use".

These so-called "standard criteria" are a fiction that allows HKR to avoid contributing to City Expenses in respect of completed and developed properties under its control, at the expense of all other Owners in Discovery Bay. As the Government now pays Management Fees for the properties that it controls on the Lot, including the Community Centre, the Government is also an injured party.

In reality, the "standard criteria" describe the obligation of the Purchaser of a Residential, Commercial or Other Unit to contribute to Village and City Expenses. The following is extracted from the Phase 14 (Amalfi) Agreement for Sale and Purchase (Page 6):

7. The rents and profits shall be received and all outgoings shall be discharged by the Vendor up to and inclusive of the actual day of completion, and as from but exclusive of that day all outgoings shall be discharged by the Purchaser. All such rents, profits and outgoings shall, if necessary, be apportioned between the Vendor and the Purchaser and paid on completion.

Applying this to the First Purchaser, the Purchaser is responsible for all outgoings after the date of completion (ref, "when the first purchaser of a Unit in a Village is expected to take possession of his Unit"). Prior to this, the developer, HKR, is responsible for all outgoings. The

Agreement for Sale and Purchase makes specific provision for the apportionment of charges between HKR and the Purchaser. As the accounts of the Village commence from the issue of the Occupation Permit, any Management Fees due prior to completion should be paid by HKR.

Calculation of Management Fees avoided by HKR

I have prepared a very rough calculation to show the total amount of Management Fees for City Expenses that HKR has avoided during the past three years due to the failure of your Company to charge Management Fees for City Expenses from the date of issue of the Occupation Permit (Appendix A).

This calculation shows that, between 1st April, 2011, and 31st March, 2013, HKR avoided some \$5.1 million in Management Fees. Specifically, HKR avoided paying Management Fees for Residential Phases 14 and 15 (Occupation Permit issued on 2nd February, 2011) and Hotel Auberge (Occupation Permit issued on 16th April, 2012).

The Manager first charged Management Fees to Hotel Auberge on 1st March, 2013, the date that the hotel commenced commercial operations. The Manager only charged Management Fees for Phase 14 (Amalfi) with effect from 1st June, 2013 (the date of completion by the First Purchaser). No Management Fees have yet been charged in respect of Phase 15 (Positano).

It must at all times be remembered that any contribution to City Expenses that HKR avoids must instead be paid by the other Owners. I have not subjected all previous developments and redevelopments in Discovery Bay, both Residential and Commercial, to the same scrutiny as I have given to the most recent developments. However, I suspect that further investigation will reveal that similar transfers of benefit have occurred in the past.

For the properties surveyed in the current review alone, HKR has avoided paying over \$5 million in Management Fees. The sum is rising each month, as Phase 15 has not yet been put on sale and there is no indication of the completion date for the First Purchaser. For 2013-14, I estimate that the additional Fees avoided will total over \$1 million.

Even though HKR did not pay Management Fees for the subject developments, these areas have all along enjoyed all City services, including access via the City roads, use of City utilities (for example, supply of potable and flushing water to all Units), the protection of City security, City landscaping services and other City management services. HKR relied on many of these services to complete its development projects. These services also provide the environment that supports HKR's sales activities.

Yours sincerely,

Enclosure:

- A. Appendix A: MU Allocation and Rough Estimate of Underpayment by HKR

Appendix A

DISCOVERY BAY CITY OWNERS' FUND

MU Allocation and Rough Estimate of Underpayment by HKR

VILLAGE	M.U.
HEADLAND	4,958
BEACH	5,126
PARKRIDGE	3,192
MIDVALE	3,856
PARKVALE	4,728
HILLGROVE	2,394
PARKLAND	861
PEN NSULA	13,760
GREENVALE	10,314
DB PLAZA	1,004
LA VISTA & LA SERENE	3,367
BIJOU HAMLET	506
LA COSTA	2,407
NEO HORIZON	1,569
SIENA ONE	3,118
SIENA TWO - A	1,201
SIENA TWO - B	4,768
CHIANTI	4,933
COMMUNITY CENTRE	196

HKR MU

HOTEL (OP 16 APRIL 2012)	3,583
AMALFI (OP 2 FEB 2011)	1,592
PHASE 15 (OP 2 FEB 2011) (Guess, as Sub-DMC not available)	1,998
INFORMATION CENTRE (BIRD HOUSE)	4
DB COMMERCIAL SERVICES I	584
DB COMMERCIAL SERVICES II	1,100
RECREATION CLUB	334
RECREATION CLUB - Siena Club Hse	450
GOLF CLUB	439
MAR NA CLUB	86
DB NTERNATIONAL SCHOOL	10
DISCOVERY COLLEGE	10
DISCOVERY BAY OFFICE CENTRE	325
S.K.H. Wei Lun	10
DBN COMMERCIAL CENTRE - BLOCK 6 (SHOPPING CENTRE)	906
DBN COMMERCIAL CENTRE - (EXISTNG SALES OFFICES)	210
HKR - SALES OFFICES EXTENSION	41
DBN - HOME OFFICE	460
DBN - PUBLIC RECREATION CENTRE	452
DBN - CLOCK TOWER	4
TOTAL MU	<u>84,856</u>

MU BY DBSML IN 2011-12 and 2012-13	77,683
OF WHICH HKR MU	5,425
\$ PER MU 2011-12	\$566.81
\$ PER MU 2012-13	\$539.77

MU ACTUAL FY 2011-12	81,273
OF WHICH HKR MU	9,015
2011-12 SHARED CITY EXPENSES	44,031,763
\$ PER MU	\$541.78
HKR PAID	\$3,074,962.53
HKR SHOULD HAVE PAID	\$4,884,110.88
HKR UNDERPAYMENT 2011-12	\$1,809,148.35

ACTUAL FY 2012-13	84,856
OF WHICH HKR MU	12,598
2012-13 SHARED CITY EXPENSES	41,931,211
\$ PER MU	\$494.15
HKR PAID	\$2,928,270.27
HKR SHOULD HAVE PAID	\$6,225,245.08
HKR UNDERPAYMENT 2012-13	\$3,296,974.80

TOTAL UNDERPAYMENT 2011-13	\$5,106,123.15
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