

The Auditor-General
Audit Report No.44 2004–05
Performance Audit

Defence's Management of Long-term Property Leases

Australian National Audit Office

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Canberra ACT
25 May 2005

Dear Mr President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit across agencies in accordance with the authority contained in the *Auditor-General Act 1997*. I present the report of this audit and the accompanying brochure to the Parliament. The report is titled *Defence's Management of Long-term Property Leases*.

Following its tabling in Parliament, the report will be placed on the Australian National Audit Office's Homepage—<http://www.anao.gov.au>.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Ian McPhee', is positioned above the printed name.

Ian McPhee
Auditor-General

The Honourable the President of the Senate
The Honourable the Speaker of the House of Representatives
Parliament House
Canberra ACT

AUDITING FOR AUSTRALIA

The Auditor-General is head of the Australian National Audit Office. The ANAO assists the Auditor-General to carry out his duties under the *Auditor-General Act 1997* to undertake performance audits and financial statement audits of Commonwealth public sector bodies and to provide independent reports and advice for the Parliament, the Government and the community. The aim is to improve Commonwealth public sector administration and accountability.

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Abbreviations

ADC	Australian Defence College
AGS	Australian Government Solicitor
AVO	Australian Valuation Office
CBD	Central Business District
CEI	Chief Executive Instructions
CFO	Chief Finance Officer
CMC	Comprehensive Maintenance Contract
CNL	Commonwealth National Lease
CPGs	Commonwealth Procurement Guidelines
CPPs	Commonwealth Property Principles
CSIG	Corporate Services and Infrastructure Group
Defence	Department of Defence
DEMS	Defence Estate Management System
DNSDC	Defence National Supply and Distribution Centre
DIDS	Defence Integrated Distribution Services
DISC	Defence Infrastructure Sub-Committee
DPS	Directorate of Property Services
Finance	Department of Finance and Administration
FMA Act	<i>Financial Management and Accountability Act 1997</i>
FMA Regs	<i>Financial Management and Accountability Regulations 1997</i>
GST	Goods and Services Tax
IRR	Internal Rate of Return
ITR	Invitation To Register
KPIs	Key Performance Indicators
LAA	<i>Lands Acquisition Act 1989</i>
MPSs	Minimum Performance Standards
NOD	National Operations Division
NPV	Net Present Value
RBA	Reserve Bank of Australia
RFT	Request For Tender

Summary and Recommendations

Summary

Background

1. The Department of Defence (Defence) operates one of the largest real estate portfolios in Australia, comprising both owned and leased property. Leased property has significant expenditure implications for Defence. Defence leases approximately 350 properties with annual rental commitments in the order of \$80 million. Lease rental commitments over the initial lease term for those properties are in the order of \$1 billion (exclusive of Goods and Services Tax (GST)). Ten of these leases have resulted from the sale of property from the Defence Estate with leaseback arrangements to the Government, represented by Defence. Properties sold and leased back comprise five office properties, two industrial properties, two residential properties and one training college.¹
2. The sale and leaseback of Defence property commenced in 2000–01, following a joint review of the Defence Estate by Defence and the Department of Finance and Administration (Finance). Sales from the Defence Estate were pursued to contribute to the Budget outcome and to accord with Government policy on property ownership.² Proceeds from property sale and leaseback transactions, up to a target set through the Budget process and based on estimated sale proceeds, were required to be returned to the Budget. The first two sale and leaseback processes were managed by Finance. Subsequent sale and leaseback processes were managed by Defence.
3. Sale proceeds from properties sold and leaseback by Defence amount to \$594 million, of which the six properties reviewed in the audit account for \$472 million. In 2003–04, Defence paid \$46.4 million in rent for these six properties which amounted to approximately 60 per cent of Defence's property rental payments in that year. The rental commitment over the initial lease period for the six properties reviewed in this audit is \$604 million. Should Defence exercise the option periods in the six leases then the rental commitments would amount to \$1.2 billion.
4. The range of responsibilities retained by Defence in the leases for properties sold and leased back by Defence, are broader than those assumed under standard expenditure leases where Defence is lessee of the property.

¹ Office properties include: Defence Plaza Sydney; Defence Plaza Melbourne; Hydrographic Office Wollongong; Campbell Park Offices; and the Royal Edward Victualling Yard Pyrmont. Industrial properties include the Defence National Storage and Distribution Centre Moorebank and the Logistics Facility Winnellie. Residential properties include Lady Gowrie House Bondi and Endeavour House Coogee. The training college is the Australian Defence College Weston Creek.

² Properties considered to contribute directly to Defence capability are retained on public interest grounds. Surplus property, not required for capability purposes, are considered for disposal.

This is particularly the case for the three leases reviewed covering whole of land and building, namely Campbell Park Offices, the Defence National Storage and Distribution Centre (DNSDC) Moorebank and the Australian Defence College (ADC) Weston Creek. Property management services, including for leases, are outsourced to an external provider under the Property Services Contract.

Audit approach

5. The objective of the audit was to examine Defence's management of leases that have resulted from property sale and leaseback transactions. Leases subject to review were for a period of ten or more years and included the following six properties: the Defence Plazas in Sydney and Melbourne; the Hydrographic Office Wollongong; DNSDC Moorebank;³ Campbell Park Offices in Canberra; and ADC Weston Creek in Canberra.

6. The audit examined the process for identifying the properties for sale and leaseback and the sale approval process. The audit sought to determine the basis on which the properties were proposed for sale and leaseback and the financial impact for the Government. The audit also reviewed the lease terms and conditions to determine whether they protect the Government's interests, and examined Defence's management of commitments arising from the leases.

Key findings and conclusions

Financial management

7. The decision to approve complex financial transactions should consider the component parts of the transaction. The transactions reviewed in the audit comprised both a decision to sell property and a decision to enter into a contract for a long-term leaseback arrangement with commitments spanning 10 to 20 years.

8. Following the identification of properties for possible sale and leaseback from the joint review of the Defence Estate by Defence and Finance, Defence undertook to base the sale and leaseback program on cost-effective business cases over time. The outcome of the review commissioned by Defence and completed on 6 March 2000 was that the Government would be better off retaining ownership of the properties in all cases. The review report to Defence did not apply the principles endorsed by Government on property ownership as it stood at the time. The Government had decided in 1996 that the Commonwealth should retain ownership of property if it met a hurdle rate of return of 14 to 15 per cent, or if it was otherwise in the public interest to retain

³ DNSDC Moorebank is the largest single warehousing and distribution centre for Defence inventory.

the property. Finance engaged a consultant on 8 March 2000 to review the report to Defence. The report to Finance applied Government policy on property as it stood at the time and supported divestment of all of the properties for the preferred lease terms by applying the higher hurdle rate of 14 to 15 per cent included in the Commonwealth Property Principles (CPPs) in its analysis.⁴

9. The Government agreed in April 2000, in the context of the 2000–01 Budget process, to the sale and leaseback of the Defence Plaza properties in Sydney and Melbourne, the Hydrographic Office Wollongong and DNSDC Moorebank.⁵ The business case methodology supporting the submission to Government by Finance and Defence to the properties proposed for sale and leaseback in 2000–01 was an assessment of the consistency of the transaction with the CPPs.⁶ Defence's objective was to implement the Government's property disposals program and to meet revenue targets. Defence advised ANAO that it 'implemented the sale and leaseback of the properties in line with these Government decisions.'

10. The Government's financial framework provides that financial transactions should represent efficient and effective use of resources in addition to complying with Government policy. Where these two requirements are, or may be, inconsistent it is sound administrative practice to inform Minister(s) of the inquiries undertaken and seek their consent before proceeding with the transaction.

11. The business case analyses prepared for the properties were based on hypothetical lease terms and commencing rentals, prior to the approval of actual lease terms and conditions to be put to the market. The analyses were not updated by Defence to reflect actual rental and estimated sale proceeds prior to the sales and Defence did not make due inquiries required under legislative provisions of the *Financial Management and Accountability Act 1997* (FMA Act).⁷

⁴ A hurdle rate is the minimum return an investor requires from holding or acquiring an asset. A hurdle rate of 14 to 15 per cent was included in the CPPs in July 1996. The hurdle rate has subsequently been revised down to 11 per cent in May 2002 and to 10 per cent in July 2004.

⁵ The Government agreed in the context of the 2001–02 Budget to the sale and leaseback of Campbell Park Offices and ADC Weston Creek.

⁶ In relation to the sales managed by Finance, Internal Rate of Return (IRR) calculations were performed prior to approval of the sale of the Defence Plazas in Sydney and Melbourne to determine consistency with policy. An IRR is the discount rate at which an asset has a net present value of zero. The IRR is compared to the CPP hurdle rate to determine whether a property should be sold or retained.

⁷ Under FMA Regulation 9, a decision to spend public money must not be approved unless the approver is satisfied, after making such inquiries as are reasonable, that the proposed expenditure:

- a) is in accordance with the policies of the Commonwealth;
- b) will make efficient and effective use of the public money; and
- c) if the proposal is one to spend special public money, is consistent with the terms under which the money is held by the Commonwealth.

12. In the absence of such analysis, ANAO examined the value for money of the transactions by comparing rental payments with sales revenue. ANAO determined the implication of selling and leasing back property on a long-term basis was that, at the point of execution of the sale and leaseback transaction, the Government would be paying more to lease four of the properties than it could gain from applying the sale proceeds to paying off debt or from investing the funds in Reserve Bank of Australia (RBA) term deposits. This applied to the leases for the Defence Plaza Melbourne, the Hydrographic Office Wollongong, Campbell Park Offices and ADC Weston Creek.

13. Significant rent increases have since resulted from the application of market related rent review processes for the two Defence Plaza properties in the context of buoyant commercial property markets, and a redefinition of the area leased at the Defence Plaza Melbourne property for security reasons. Two years into the lease terms, the rent had increased by 23 per cent from the commencing rental for the Defence Plaza Sydney, and by 43 per cent for the Defence Plaza Melbourne. The major component of the increases arose from the 1 July 2003 rent review to market which resulted in rent increases of 19 and 33 per cent respectively for the Sydney and Melbourne office properties. Analysis taking account of the actual rent review outcomes to date for the Defence Plaza properties indicated funds invested from those sales are likely to be exhausted by the rental commitments during year 10 in the case of Defence Plaza Sydney and year 8 in the case of Defence Plaza Melbourne.

14. In October 2004, Defence implemented a revised process for the disposal of Defence property requiring detailed business case analyses to form the basis of disposal decisions. Future sale and leaseback transactions will require a value for money assessment by Defence officials to arrive at a detailed business case. This process will accord with sound administrative practice for the sale of property and the entering into contractual commitments under a lease.

15. ANAO did not find evidence within Defence of approval for the commitments arising from expenditure payable under the six leases. Documentation reviewed indicated that Defence considered its financial exposure in property sale and leaseback arrangements would be mitigated by the provision of Budget supplementation for rental commitments and statutory charges payable under the leases. Defence advised ANAO in March 2005 that procedures have now been put in place to ensure that statutory approvals are formally obtained and documented.

16. Five of the six property leases reviewed in the audit have been classified by Defence as operating leases for accounting purposes. Subsequent to the sale process, Defence reclassified the lease for the ADC Weston Creek property as a finance lease in the reporting of Defence's financial position for 2003–04.

Lease management

17. Payments transacted in 2003–04 under the leases for the six properties reviewed were assessed by ANAO to be consistent with lease obligations, including rental commitments which accorded with rent review provisions.

18. Benchmarking activities documented in the 2003–04 and 2004–05 Business Plan for Property Management Services have progressed slowly. The Property Management Contractor undertook to benchmark the Defence property portfolio against comparable properties within its client base which has yet to occur. ANAO considers the establishment of appropriate benchmarks for property operating costs would serve as a useful comparator for the costs of occupying leased property by Defence.

19. The management of the breadth of lease responsibilities assumed by Defence in the leases reviewed is spread across a number of areas within Defence, with some of the services provided in-house and some outsourced via service contracts. ANAO considers there is a need for lease management responsibilities to be clearly defined within Defence.

20. The Property Services Contract was market tested by Defence through the conduct of a competitive tender process in 2002–03. The incumbent service provider was awarded a new contract commencing from 1 July 2003 for a term of four years with options for extensions of up to a further four years. ANAO found that the tender process was effectively managed and the resulting contract addressed problems identified in the previous contract and reported in ANAO Audit Report No.58 2000–01, *Defence Property Management*.

21. The current Property Services Contract has improved linkages between the assessment of Contractor's performance against Key Performance Indicators (KPIs) and the payment for services. However, the review of Contractor performance for 2003–04 had not been finalised at the time of the audit to determine the Contractor's eligibility for incentive payments. While the contract includes performance criteria that have been developed down to a task level, those measures were found by ANAO to have little utility given that performance reporting is based on general high-level KPIs. ANAO did not evidence the conduct of audits or spot checks of processes performed by the Contractor or of documentation held by the Contractor, as provided for under the contract.

Commitment management

22. ANAO found that a comparison of the terms and conditions of the Commonwealth National Lease (CNL)⁸ with the lease for Campbell Park Offices highlighted the extent of the lease obligations Defence has committed to as lessee. Under the CNL the only lessee obligation for repair and maintenance relates to the interior of the property occupied. In the Campbell Park Offices lease, Defence has assumed the additional obligation to maintain building services, plant and equipment. While not commercial office properties, the leases for ADC Weston Creek and DNSDC Moorebank also impose similar repair and maintenance obligations on Defence. It is not common practice for Defence to assume such repair and maintenance commitments in expenditure leases negotiated by Defence. In addition, Defence has assumed responsibility for environmental remediation over the lease term for the DNSDC Moorebank property.

23. The Defence Estate Management System (DEMS), which stores information on lease repair and maintenance commitments, has not been entirely effective in assisting in the ready identification of lease related responsibilities of Defence and property owners. Defence advised ANAO that an upgrade to that system is scheduled to commence in March/April 2005.

24. The property leases reviewed do not include performance standards for completion of property owner repair and maintenance obligations. Defence has advised that the absence in the leases of required turnaround times for the owner's completion of referred works has been noted for future improvement.

25. The leases provide for Defence to notify the property owners of its requirements relating to security and confidentiality at its absolute discretion. The owner is required to comply with those requirements, thereby providing Defence with adequate control over security of the properties. The security arrangements in place prior to sale generally did not change with the passing of ownership of the properties to the private sector. As well, the lease terms and conditions provide for any revised arrangements to be put in place if required by Defence and for those requirements to be followed by the owner. A shortcoming in security at the Defence Plaza Melbourne property has been addressed through a lease variation. The variation revised the definition of the space leased by Defence to include additional space on the ground floor, and necessarily resulted in an increase in rental payments for the property.

⁸ The CNL was developed by Australian Government Solicitor (AGS) to provide a benchmark for the acquisition by lease of commercial office accommodation for Government agencies. The CNL has been designed to produce a balanced allocation of risk between the property owner and tenant. Defence has developed a standard lease based on the CNL.

26. ANAO found that there was a lack of effective administration by Defence of the insurance for properties sold and leased back by Defence, to ensure that insurance coverage remained consistent with the terms and conditions of the leases. Neither Defence nor the Contractor for property management services held copies of current insurance policies for the properties reviewed.

27. Procedures were not followed by Defence for the inclusion of indemnities in lease documentation resulting from property sale and leaseback transactions. There was no evidence that indemnities provided in the leases were taken into account in considering value for money of the sale and leaseback transactions. Risk assessments were not performed prior to execution of the leases; and legal advice was not obtained as to whether risks covered by those indemnities would be included in the general indemnity insurance held by Defence with Comcover. Following audit review, Defence has now recognised in the Defence Indemnities Register its liabilities for indemnities arising from these leases.

Overall audit conclusions

28. The sale of the six properties reviewed was consistent with annual Defence property sale programs approved by the Government through the Budget process. ANAO analysis indicates that the Government's total rental payments over the lease terms, and the opportunity cost of making those payments, in relation to four of the six properties reviewed, could be greater than the return that could be generated from investing the sale proceeds over the lease terms. For all properties other than the Defence Plazas in Sydney and Melbourne, the annual rent increase is 3 per cent over the term of the lease. A combination of percentage rent increases and market rent reviews have imposed significant rent increases for the Defence Plazas, Sydney and Melbourne. Since commencement of the leases, annual rent for these two properties has increased by 23 per cent and 43 per cent respectively.

29. ANAO assessed that the tender process for the provision of outsourced property management services from 1 July 2003 was effectively managed; and sound contractual arrangements have been put in place for the financial management of expenditure leases and the management of performance by the contractor. ANAO identified scope for improvement in the measurement of contractor performance.

30. ANAO found that Defence's management of leases resulting from property sale and leaseback transactions has generally been effective. Defence has implemented revised procedures, effective from October 2004, requiring business case analyses to be prepared as part of the property disposal process, including for properties to be sold and leased back.

31. The terms and conditions of the leases for properties sold and leased back by Defence were generally found by ANAO to be more extensive than those included in standard Defence expenditure leases based on the CNL in the case of three properties where Defence leases the whole of land and building. To varying degrees across the properties, Defence has retained responsibility for repair and maintenance and other property related costs including for energy and insurance. Defence has not effectively managed, nor reported on, the risk exposure assumed by the Government from indemnities included in the leases.

Agency response

32. The ANAO made three recommendations aimed at improving Defence's management commitments arising from long-term property leases. The Department of Defence agreed with those recommendations.

Recommendations

Recommendation No.1

Para 3.9

ANAO recommends that, to assist in the management of lease commitments resulting from sale and leaseback transactions and the identification of the costs of occupancy, Defence develop a detailed schedule of commitments assumed under those leases and the responsibilities for the commitments.

Defence response: Agreed.

Recommendation No.2

Para 4.27

ANAO recommends that, to ensure that property lease obligations retained by Defence for repair and maintenance are managed consistently and effectively:

- (a) sufficient information on lease terms and conditions be provided through the Defence Estate Management System for access by outsourced providers of repair and maintenance services to determine the respective responsibilities of Defence and the property owner; and
- (b) future leases negotiated by Defence include performance standards for owner obligations for building services, plant and equipment and structure.

Defence response: Agreed. Preparation to include the information referred to in (a) in the Defence Estate Management System is already underway.

Recommendation No.3

Para 4.45

ANAO recommends that, to better manage lease commitments for insurance for properties sold and leased back, Defence:

- (a) routinely perform a risk assessment of the insurance commitments proposed under the leases and quantify the exposures;
- (b) assess the compliance of the current insurance policies with executed lease terms and conditions; and
- (c) implement procedures to better manage exposures arising from indemnities provided to the owners of the properties.

Defence response: Agreed.

Audit Findings and Conclusions

1. Introduction

This chapter provides an overview of Defence lease commitments for property, lease management arrangements and of the audit approach.

Background

1.1 The Government policy framework for property ownership comprises a property disposals policy and a set of policy principles to be used to guide the decision to either retain or divest property. The 1986 Commonwealth Property Disposals Policy provides for property with no alternate efficient use to be sold on the open market. Exceptions to that policy include priority and concessional sales.⁹

1.2 The Government policy on property ownership is more recently contained in the CPPs established in 1996 and updated in May 2002 and July 2004.¹⁰ The CPPs outline the basis for continued property ownership by the Government and include a hurdle rate of return to guide that decision. To identify whether property in the Defence Estate is surplus and can be considered for disposal, Defence initially reviews whether the property is required for capability purposes. Properties considered to contribute directly to capability are retained on public interest grounds.

1.3 During deliberations for the 1999–2000 Budget, Cabinet agreed that Defence and Finance would jointly examine Defence property for sale, and sale and leaseback. The sales from the Defence Estate would follow the three year property divestment program of the Commonwealth domestic estate managed by Finance that generated proceeds of approximately \$1 billion.¹¹ Of the 400 Defence properties identified at the time of the joint property review by Defence and Finance, 50 properties were initially identified for consideration and 30 were reviewed for sale, or sale and leaseback.¹²

1.4 Ten properties have now been sold from the Defence Estate and leased back by Defence. The inclusion of those properties in annual Defence property

⁹ Priority sales are those made direct to a purchaser without the property having first been offered for sale on the open market and in certain circumstances require the approval of the Minister for Finance and Administration. Concessional sales are priority sales concluded at a price below market value and require the approval of the Minister for Finance and Administration.

¹⁰ The CPPs were renamed as the Australian Government Property Principles on 1 July 2004.

¹¹ The divestment program focussed on the Commercial Office Estate managed by Finance and covered the period 1997–98 to 1999–2000.

¹² Four of the properties examined in this audit were included in the review. At that time, Campbell Park Offices was administered by Finance and was not part of the Defence Estate. Also, the various service staff colleges had not been consolidated to form the ADC Weston Creek.

sale programs was approved by the Government through the Budget process for the year of sale.

1.5 The first two sale and leaseback transactions, for the Defence Plaza properties in Sydney and Melbourne, were managed by Finance in 2000–01. The process for the third property sold and leased back in 2000–01, the Hydrographic Office in Wollongong, and a further seven properties in subsequent years were managed by Defence. The sale and leaseback transaction for Campbell Park Offices was concluded in 2001–02. Other transactions proposed for that year were postponed.¹³ Five sale and leaseback transactions were concluded in 2002–03 and the final sale and leaseback transaction was concluded in 2003–04.

1.6 The sale and leaseback of property generally involves the following processes:

- preparation of a business case, supporting a sale and leaseback transaction;
- approval of lease terms and conditions, to meet user requirements;
- selection and approval of a preferred purchaser, resulting from a tender process conducted in accordance with an approved tender evaluation plan;
- approval to enter into commitments under the lease, including financial and contingent liabilities; and
- approval of sale and lease documents, including approvals under the *Lands Acquisitions Act 1989* (LAA), a contract for sale and a lease.

1.7 The audit examined the management of six of the ten property leases resulting from property sale and leaseback transactions, including compliance with these processes. The other four property leases were not reviewed due to the short-term nature of the leases¹⁴ or the low value of the rental commitments over the lease terms.¹⁵ The six properties reviewed were generally built by the private sector, later purchased by the Government and then subsequently sold back to the private sector with leaseback arrangements to the Government, represented by Defence. An overview of each of the properties reviewed in this audit is provided in Table 1.1.

¹³ The transactions were postponed due to delays in the tendering process for the outsourcing of services provided at those sites, or due to rezoning, planning issues or ongoing review of Defence requirements.

¹⁴ For the purposes of this audit, long-term leases are defined as those with terms of 10 years or more.

¹⁵ Those four properties are the Logistics Base Winnellie, the Royal Edward Victualling Yard Pymont, Endeavour House Coogee and Lady Gowrie House Bondi.

Table 1.1**Overview of properties reviewed in audit**

Defence Plaza, Sydney	<p>Sold May 2001 for \$85 million, with 10 year leaseback and two five year options to extend.</p> <ul style="list-style-type: none"> • 25 level office building with 48 car parks located in the Central Business District (CBD). • Constructed by the private sector 1990, purchased by Defence 1994, and refurbished 1995. • Defence sole tenant.
Defence Plaza, Melbourne	<p>Sold June 2001 for \$40 million, with 10 year leaseback and two five year options to extend.</p> <ul style="list-style-type: none"> • 11 level office building with 64 car parks located in the CBD. • Constructed by the private sector 1990, purchased by Defence 1994, and refurbished 1995. • Office tower attached to a heritage listed building used as a café, which is privately tenanted. • Defence sole tenant of office space.
Hydrographic Office, Wollongong	<p>Sold June 2001 for \$7 million, with 10 year leaseback and two five year options to extend.</p> <ul style="list-style-type: none"> • Six level office building including 45 car parks located on the fringe of the CBD, constructed seven years ago. • Services provided at site include operational surveying support and information for ADF operations and exercises. • Defence sole tenant.
Campbell Park Offices, ACT	<p>Sold June 2002 for \$99 million, with 20 year leaseback and one five year option to extend.</p> <ul style="list-style-type: none"> • Seven level office building and 1340 car parks in remote bushland location four kilometres from the CBD. • Built mid-1970s, acquired from Finance by Defence in 1999 at a cost of \$9.5 million, refurbished 2000-01. • Defence sole tenant.
DNSDC Moorebank NSW	<p>Sold March 2003 for \$209 million, with 10 year leaseback and two five year options to extend.</p> <ul style="list-style-type: none"> • Warehouse facility utilised for workshop, storage and manufacturing purposes. 90 buildings located 35 kms south west of the Sydney CBD. • Buildings are a combination of older industrial buildings built in the 1940s (some re-clad in 1990s) and modern warehousing. • High security premises with Defence sole tenant.
ADC Weston Creek ACT	<p>Sold June 2003 for \$32 million, with 20 year leaseback and one 10 year option to extend.</p> <ul style="list-style-type: none"> • Educational establishment located in south Canberra providing formal tri-Service training. • Comprising five main buildings, three of which were constructed in 1994. Refurbishment and construction continued over the period 1999-2002. • Defence sole tenant.

Source: ANAO analysis of Defence and Finance documentation.

Sale documentation

1.8 The sale processes were out of scope of the audit, however approved tender evaluation reports were identified and reviewed for all sale and leaseback transactions and were supported by approved tender evaluation plans.¹⁶

1.9 The sale and leaseback of property is authorised under the LAA administered by Finance. Sections 40 and 119 provide for the transfer of ownership of land and acquisition of interests in land. Finance exercises the authority to dispose of land, but has delegated the authority for Defence to enter into arrangements for the lease of property. Defence has exercised its delegated authority to lease the properties, however ANAO did not sight the LAA approval for the lease of the Hydrographic Office Wollongong, as records were not available.

1.10 Finance was unable to locate signed copies of the LAA approvals for the two Defence Plaza properties. Finance advised ANAO in March 2005 that the inability to locate copies of the LAA approvals was most likely a filing error and does not mean the forms were not approved at the time of the sale and leaseback transaction. Executed contracts for sale and executed leases were evidenced for the six transactions. Finance further advised ANAO in April 2005 that:

As normal practice for sale and leaseback transactions, Finance would have executed pre-sale legal documentation, such as lease contracts and LAA approvals, concurrently as a package. In line with this practice, the LAA documents for the Defence Plaza properties were prepared by Finance's legal advisers and provided to Finance to execute. Copies of the unexecuted LAA documents are on the relevant files. Legal advice indicates that even if the LAA approvals had not been signed, the sale and lease transactions would not have been invalidated or otherwise affected.

Lease commitments

1.11 Total Defence lease commitments as at 30 June 2004 amounted to approximately \$1 billion, based on annual rental payments for all current expenditure leases over the initial lease terms. In addition to this amount, Defence has further commitments under the leases for repair and maintenance of the properties, service and statutory charges, and insurance premiums over the terms of the leases. Defence also carries contingent liabilities for

¹⁶ The sale of the Hydrographic Office, Wollongong was the exception to this process in that it involved a two stage expression of interest, and the selection of a purchaser was not assessed against a tender evaluation plan as one was not developed. The sale was completed with the highest priced conforming bidder.

indemnities provided to property owners in those leases. Lease terms range from two months to 20 years.

1.12 Table 1.2 details properties sold from the Defence Estate with long-term leaseback arrangements, and the rental commitments arising from those leases over the initial terms of the leases as estimated by ANAO. The rental commitments for the six long-term leases reviewed by ANAO have been estimated at \$604 million applying rental reviews at lease inceptions.

Table 1.2

Total rental commitments for properties sold with long-term leaseback arrangements at lease inceptions

Property	Rental commitment ^a		
	Initial lease period \$m	Option period \$m	Total \$m
Defence Plaza, Sydney	107	175	282
Defence Plaza, Melbourne	52	84	136
Hydrographic Office, Wollongong	12	18	30
Campbell Park Offices, ACT	213	76	289
DNSDC Moorebank, NSW	160	216	376
ADC Weston Creek, ACT	60	46	106
Total	604^b	615	1 219
Notes:			
(a) Rental commitments have been calculated exclusive of GST. Calculations are based on rent at lease commencement and rent review processes outlined in the leases have been applied (annual escalator of 3 per cent, except in the case of market reviews where a 7 per cent increase has been assumed). The opportunity cost of funding rental payments has not been included.			
(b) The rental commitment over the initial term for the other four properties sold and leased back, and not included in audit coverage, amounts to \$25 million. If the option periods for those properties are exercised, the rental commitment increases to \$29 million. The total sale price for the properties was \$122 million.			

Source: ANAO analysis of executed leases for the properties.

1.13 The leases that result from sale and leaseback transactions differ from other Defence expenditure leases in terms of the commitments assumed by Defence. Those leases were negotiated as part of the property sale process by the area managing the property sales. In contrast, expenditure leases are generally negotiated by the area responsible for property management activities. The lease terms and conditions for Campbell Park Offices, DNSDC Moorebank and ADC Weston Creek are more extensive in that Defence continues to assume responsibility for repair and maintenance activity to various levels following the property sales, and pays a net rent with obligations for additional charges.

Lease management arrangements

1.14 The Defence Estate is managed by the National Operations Division (NOD), with the strategic management of the Defence Estate the responsibility of Infrastructure Division (excluding property administered by the Defence Housing Authority). Both NOD and Infrastructure Division are part of the Corporate Services and Infrastructure Group (CSIG) of Defence.

1.15 The Directorate of Property Services (DPS), within NOD, is responsible for managing Defence's acquisition and leasing of property and property management activities specific to the Defence Estate.¹⁷ Defence has contracted out the provision of property management services for Defence's portfolio of leases and DPS is responsible for managing the Property Services Contract.¹⁸ The contract covers both revenue¹⁹ and expenditure leases. This audit focuses on the management of expenditure leases executed following the sale of Defence property to the private sector.

1.16 Provision of full property management services under the current Property Services Contract commenced on 1 July 2003 for a term of four years, with extension options. For expenditure leases, exclusive services provided by the property management services contractor (the Contractor) include: lease and financial management; and regulatory compliance, including the management of risk and compliance with lease obligations. While Defence has outsourced the provision of property management services, it retains responsibility and accountability for the management of lease terms and conditions.

¹⁷ In December 2002, DPS was transferred from Infrastructure Division to NOD in recognition that the governance of property management could be improved by aligning the central management function of DPS with the regional delivery of services function (NOD is the service delivery arm of CSIG).

¹⁸ The Services Contract between the Commonwealth of Australia, represented by Defence, and the Contractor will be referred to as the Property Services Contract in this report.

¹⁹ A revenue lease is where Defence is the lessor and the Defence owned property is used by a third party.

1.17 In 2003–04, the Contractor for property management services managed some \$48.8 million of expenditure for the six properties subject to audit,²⁰ of which some \$46.4 million related to rent. The contract provides for a monthly management fee to be paid to the Contractor, inclusive of a performance based component for achievement against established KPIs, and for the Contractor to recover reimbursable expenses from Defence. The annual management fee is fixed over the four year term based on estimated lease activity.²¹ At the end of each financial year, the contract provides for Defence to determine whether a retrospective adjustment is required to fees paid, based on the performance of the Contractor, and whether criteria have been satisfied for a further reward payment, based on customer satisfaction.

1.18 Responsibility for commitments that Defence has retained through these leases, that fall outside of the services outsourced through the Property Services Contract, relate to the supply of electricity, repair and maintenance obligations, and other property services including cleaning, security and grounds maintenance. With the exception of the management of electricity, Defence has outsourced the provision of these services through other contracts. However, the services relating to the six properties reviewed in the audit represent only a small proportion of the services provided to Defence via those contracts. Those service contracts apply to all properties in the Defence Estate.

Audit approach

1.19 The objective of the audit was to examine Defence's management of leases for property sold with long-term leaseback arrangements to the Government. The audit focused on the leases for six properties that fall into this category of expenditure lease.

1.20 The audit examined the approval process for the sale and leaseback of Defence property, but not the actual sale process. This involved fieldwork in both Finance, responsible for the sale process for two of the properties, and Defence, responsible for the process for the other four properties reviewed.

1.21 Fieldwork for the review of the management of leases post execution was conducted in Defence between August and November 2004. Issues papers were released in December 2004, a Discussion Paper was released in February 2005, and a draft report was provided to Defence and Finance in April 2005.

²⁰ Representing 57 per cent of total expenditure managed by the Contractor.

²¹ The contract provides for a fee adjustment in the event that the scale of leases or hire agreements vary from an agreed level.

1.22 ANAO Report No.58 2001–02 *Defence Property Management* examined management of the previous contract for outsourced property management services by Defence. Findings and recommendations of that audit were considered in the review of the current contractual arrangements for those services in Chapter 3. The audit did not review performance by the Contractor, but rather Defence's management of Contractor performance.

1.23 The Australian Valuation Office (AVO) provided ANAO with specialist advice on property and leasing issues for sale and leaseback transactions reviewed in the audit.

1.24 The audit was conducted in accordance with the ANAO Auditing Standards at a cost to the ANAO of \$290 000.

Report structure

1.25 The remainder of this report is structured into three chapters. Chapter 2 examines the support for sale and leaseback arrangements, the approval process, and the financial implications of the transactions. Chapter 3 outlines the framework for the management of long-term property leases, the contractual arrangements for the management of outsourced property management services, and lease costs. Chapter 4 reviews the management of lease commitments.

2. Financial Management

This chapter examines the support for and approval of the sale and leaseback of Defence property. It also examines the financial impact of resulting long-term property leases and the funding of lease commitments.

Sale approval process

2.1 The Government policy for property sales is set out in the Commonwealth Property Disposals Policy and the CPPs. The legislative framework for the approval of sale and leaseback transactions is covered by specific delegations under the FMA Act and the LAA.²²

2.2 Property sale programs from the Defence Estate are approved by the Government and expected proceeds are incorporated in Budget estimates. The Government approved the inclusion of the six Defence properties subject to review in this audit in sale programs over the period 2000–01 to 2002–03. Defence implemented the Government's decision that each of the six properties reviewed in the audit be sold and leased back.

Potential sale and leaseback properties

2.3 The 1999–2000 joint review by Defence and Finance of Defence property identified a number of properties for potential sale and leaseback. Proposals for sale and leaseback from that review were to be supported by a business case.

2.4 Defence subsequently engaged a firm to independently assess the properties that had been selected for possible sale in the joint review. The firm was to consider whether the sales were consistent with the interests of Defence and whether the timing of the property sales was appropriate. A sale was to be considered contrary to the interests of Defence if the agency had an ongoing need to use the property and the projected costs of leasing following sale were likely to exceed the sale proceeds, or otherwise had adverse cashflow implications. The properties reviewed by the firm included seven being considered for sale and leaseback.²³

2.5 On the basis of Net Present Value (NPV)²⁴ analysis of rental commitments over a proposed lease term and estimated sale proceeds, the

²² Prior to 2001–02, Defence was able to retain property sale proceeds up to a ceiling of 1 per cent of the Defence Budget. From 2000–01, proceeds from those sales programs up to a target figure were required to be returned to the Budget and proceeds in excess of the target could be retained by Defence.

²³ Three properties were also reviewed for advice on whether they should be sold as is, or following remediation, rezoning or further development.

²⁴ The NPV is the discounted value of the expected benefits of an asset, less the discounted value of the expected costs.

report to Defence of 6 March 2000 concluded that the Government would be better off retaining ownership of all seven properties being considered for sale and leaseback. The properties relevant to this audit and included in that review were the two Defence Plaza properties, and DNSDC Moorebank. The financial analysis was performed prior to the finalisation of lease terms and conditions for marketing and expected sale prices were based on forecast rental and residual values. A discount rate of 8 per cent was applied in the calculation of the present value of the forecast rental and statutory outgoing payments.

2.6 The review report to Defence did not apply the principles endorsed by Government on property ownership as it stood at the time. The Government had decided in 1996 that the Commonwealth should retain ownership of property if it met a hurdle rate of return of 14 to 15 per cent, or if it was otherwise in the public interest to retain the property.²⁵ After receiving Defence's commissioned report, Finance engaged a consultant on 8 March 2000. The consultant's report of 10 March 2000 applied the principles endorsed by Government on property ownership as it stood at the time and supported the divestment of all the properties for the preferred lease terms. This analysis applied the then hurdle rate of 14 to 15 percent included in the CPPs.

2.7 The business case methodology applied by Finance and Defence to support the properties proposed for sale and leaseback in 2000–01 was an assessment of the consistency of the transaction with the CPPs. However, DNSDC Moorebank was not sold until 2002–03 at which time the hurdle rate included in the CPPs was 11 per cent.

2.8 In 2001, another consultant was engaged by Defence to undertake financial analyses of three further properties identified for possible sale and leaseback, including Campbell Park Offices and the ADC Weston Creek.²⁶ The firm was to determine whether there was a sound business case to support the sale and leaseback of the properties.²⁷ A draft report dated February 2002 noted that, while Defence had expressed a long-term requirement for the properties of up to 50 years, analysis was based on an initial term of 20 years.²⁸

²⁵ ANAO Audit Report No.4 2001–02 *Commonwealth Estate Property Sales* discusses further the hurdle rate of return applied in the CPPs, (see Chapter 2). The CPPs were developed by the Business Review Group (which was comprised of three private sector advisers, supported by then Department of Administrative Services and Department of Finance officers) and endorsed by Government on 31 July 1996.

²⁶ The third property reviewed was Russell Offices.

²⁷ The Minister for Defence was advised in a Minute of March 2001 that, in relation to Campbell Park Offices, 'while a business case would not support the sale and leaseback proposal (as it didn't with the other proposals last year), provided Defence is supplemented there is no real risk'. The other proposals to which this Minute refers are the Defence Plaza properties in Sydney and Melbourne.

²⁸ A final version of the report was not identified in Defence records.

2.9 The report concluded that the analysis did not support the sale and leaseback of any of the properties as the payback period for all three properties was calculated to be considerably less than the industry benchmark.²⁹ The payback periods were assessed to be during year 9 for both properties.

Point of sale approval

2.10 The IRRs developed by Finance for the Defence Plaza properties in Sydney and Melbourne were calculated at 12.4 per cent and 11.6 per cent respectively in April 2001. ANAO notes that the hurdle rate of 14 to 15 per cent applicable at that time had been set in July 1996, and was still in force as Government policy at the time of the Defence Plaza transactions. The hurdle rate included in the CPPs was subsequently revised down to 11 per cent in May 2002 and down to 10 per cent in July 2004. These reductions reflected a lowering in the Government's long term cost of funds and refinement of the methodology used by Finance to calculate the rate.

2.11 Given the hurdle rate of 14 to 15 per cent in the CPPs, approved in 1996 and still applicable at the time of sale of the Defence Plaza properties, those sales were included in sale programs in accordance with the CPPs. Financial analysis in the form of IRRs was not calculated by Defence at the time of selecting the actual preferred tenderer in the subsequent property sale processes to ensure that sale and leaseback was consistent with Government policy. At the time of the sale of DNSDC Moorebank in 2002–03, the CPP hurdle rate had been lowered to 11 per cent. However, there was no application of the revised threshold hurdle rate in the CPPs to the DNSDC Moorebank sale. An assessment against the CPPs was also not prepared for the sales of the Hydrographic Office Wollongong, Campbell Park Offices or the ADC Weston Creek.³⁰

Contractual approvals

2.12 The sale and long-term leaseback of property from the Defence Estate is a complex transaction involving both the sale of property and the entering into of contractual commitments under a lease. Approval is required for both

²⁹ The payback period was defined as the number of years required for the ongoing costs of the lease options to utilise the net revenues of the sale option. The analysis applied a discount rate of 7.5 per cent.

³⁰ The firm engaged by Defence for the 2000 review was again engaged by Defence in 2002 to independently review the divestment strategy in relation to 36 properties identified for sale in 2002–03. The analysis was based on NPV calculations assessing whether the properties should be sold in their current state, or following investment to enhance the expected return on sale. However, the scope of the review did not include consideration of retaining the properties or of the value for money of sale and leaseback proposals. The properties to be reviewed included DNSDC Moorebank and the ADC Weston Creek. The report recommended that DNSDC Moorebank be sold as is and leased back, and noted that full contamination was not known. ADC Weston Creek was not reviewed due to a lack of available information on which to make an assessment.

aspects of the transaction. The significance of that commitment for the properties subject to audit review is highlighted by the lease terms of between 10 and 20 years, or potentially longer should option periods be exercised.

2.13 The Commonwealth Procurement Guidelines (CPGs), the procurement policy framework administered by Finance, identifies value for money as the core principle underpinning Government procurement.³¹ The CPGs require value for money to be determined on a whole-of-life basis. The FMA Act provides for the making of regulations in relation to the disposal of public property. The *Financial Management and Accountability Regulations 1997* (FMA Regs) also require approvers of expenditure proposals to be satisfied that, in addition to conforming with Government policies, the proposal represents the efficient and effective use of public money.

2.14 The decision to enter into a lease between the Government and a successful purchaser of a property involves the application of FMA Regs 9 and 13. That is, the entering into the lease involves the entering into of a 'contract under which public money is, or may become payable' and is prohibited unless the proposed contract has been approved under FMA Regs 9 or 10.

2.15 Under FMA Reg 9, a decision to spend public money must not be approved unless the approver is satisfied, after making such inquiries as are reasonable, that the proposed expenditure:

- a) is in accordance with the policies of the Commonwealth;
- b) will make efficient and effective use of the public money; and
- c) if the proposal is one to spend special public money, is consistent with the terms under which the money is held by the Commonwealth.³²

2.16 Finance Chief Executive Instructions (CEIs) issued prior to the sale of the Defence Plaza properties, addressing the disposal of public property, also required that in considering any sale proposal the approver must be satisfied that the planned proposal represents value for money and secures the best financial outcome for the Department. The CEI required the executive briefing supporting the disposal of a major asset to include a full evaluation, risk assessment and consideration of all policy implications.

³¹ FMA Regulation 8(1) requires that officials performing duties relating to the procurement of property and services must have regard to the CPGs.

³² Legal advice obtained by the ANAO states that the requirements set out in these three paragraphs are cumulative. That is, there is a requirement to comply with all three paragraphs. That advice also indicated that policies of the Commonwealth would relate to policies which form the subject matter of the proposal to spend public money and the policies made under the FMA Act and Regs. These policies would consist of the: Commonwealth Property Disposals Policy; CPPs; CPGs; and, Chief Executive Instructions (CEIs).

2.17 Finance CEIs at the time of the sales represented sound administrative practice for an agency disposing of Government property with a long-term leaseback arrangement. The approving officer is required to make a number of inquiries. Defence and Finance considered whether the properties should be sold and leased back in accordance with the relevant policy in determining the consistency of the sales with the CPPs. Defence and Finance also established the full market value of the properties prior to sale for consideration in the tender evaluation for the property sales.

2.18 The inquiry into whether an agency should enter into a sale and leaseback transaction should also seek to determine if the transaction represents value for money so that the most cost-effective outcome may be achieved. Whole-of-lease costs and benefits should be taken into account in considering a sale and leaseback transaction, such as by calculating the NPV.³³

2.19 In the property sale transactions reviewed by the ANAO it was not apparent that a systematic process of inquiry, as required under the FMA Regulations and CPGs, was conducted by Defence prior to executing the sale contract and leasing arrangements with the purchasers. Whole-of-lease costs were not analysed against sale prices to ensure that sale and leaseback of the properties represented efficient and effective use of public money, as required by the FMA Regulations. In circumstances where a proposed property sale does not appear to represent efficient and effective use of resources at the time of the sale, it would be sound administrative practice to inform Minister(s) of the inquiries undertaken and seek their consent before proceeding with the transaction.

2.20 In October 2004, the Defence Infrastructure Sub-Committee (DISC)³⁴ approved a revised property disposal process. This requires detailed business cases (including a value for money assessment) to form the basis of disposal decisions and future sale and leaseback transactions. The revised approach incorporates two stages of review by the DISC to determine the feasibility of proposed property disposals. This process aligns with the Asset Development Process in CSIG, which requires the development of strategic and detailed business cases to support proposals involving material expenditure for DISC

³³ The only value for money assessment identified in ANAO reviews of Defence papers related to the sale and leaseback process for Campbell Park Offices. However, the assessment was conducted after the sale process was completed and therefore did not assist the approver in ensuring that the sale and leaseback represented efficient and effective use of resources as required under the FMA Act when approving the spending of public money.

³⁴ The DISC, chaired by Head Infrastructure, is responsible for considering expenditure proposals for the Defence Estate relating to capital investment, private financing and leasing. It comprises senior executive representatives from across Defence.

approval.³⁵ The ANAO supports a process that results in sale and leaseback transactions based on business case analysis.

ANAO financial analysis

2.21 ANAO performed analysis of the value for money of the property sale and leaseback transactions. An estimate of the cost of the rental commitments over the term of the leases, and the opportunity cost for financing lease payments, has been assessed by ANAO against the investment of the potential proceeds from sale. Analysis undertaken for the ANAO by the AVO indicates that a breakeven point could be reached before the end of the lease term in the case of the Defence Plaza Melbourne, the Hydrographic Office, Campbell Park Offices and ADC Weston Creek.³⁶ After that breakeven point, the Government could be paying more for the leaseback arrangement than it could gain from investment of the sale proceeds. The invested funds from the sale proceeds will be exhausted, including the earnings on invested proceeds.

2.22 ANAO analysis of financial returns to the Government is based on the following assumptions:

- the opportunity cost of the payment of monthly rental commitments in advance over the term of the lease is the interest forgone on Government cash reserves held in the Official Public Account;
- sale proceeds (exclusive of GST)³⁷ are invested for the term of the lease at the 10 Year Treasury bond rate at the point of sale;
- cost of sales represent 2 per cent of the purchase price; and
- annual rental increments are applied as per the lease terms and conditions. Where the leases provide for rent review to market, the

³⁵ The revised process is in line with Recommendation No.1 of ANAO Audit Report No.1 2004–05, *Sale and Leaseback of the Australian Defence College Weston Creek*.

³⁶ ANAO sought property and valuation advice from the AVO on the terms and conditions of the sale of the ADC Weston Creek property in the performance audit of the sale and leaseback of that property. AVO advice included in ANAO Audit Report No.1 2004–2005 *Sale and Leaseback of the Australian Defence College Weston Creek* at page 39 was:

The lease growth rate is fixed at 3 percent per annum for the period of the lease. At the date of sale the possibility of interest rate increases were positive and upward movements in investment rates were forecast. To lock into a 20 year lease with a fixed 3 percent rental growth based on a market rent, results in a worst case outcome of a 14 year breakeven point. This is an acceptable longer term investment decision for freeing up capital.

³⁷ The purchasers were required to pay a 10 per cent deposit and, on completion of the property sales, the balance of the sale price. The tax invoice issued by the Government to the purchasers was to show the sale price (which is GST inclusive) and state that the 'total amount payable includes GST'. After completion the Government would need to account for the GST (equal to 1/11th of the sale price including the deposit) in the normal manner for the period in which any invoice is issued or in which any part of the sale price was received, whichever is the earlier.

AVO has provided ANAO with an estimate of potential rent movements.

2.23 The interest rate applied in the analysis to the monthly rental payments is the RBA cash rate target at the point of sale less 10 basis points.³⁸ ANAO also did sensitivity testing using the average rate of funds earnings by the Australian Office of Financial Management on term deposits at the RBA. This did not have a material effect on the analysis.

2.24 The year in which the invested funds from the property sales are exhausted by the rental commitments under the leases for the six properties reviewed by ANAO are detailed in Table 2.1.³⁹

2.25 The conditions for annual rental increases vary across the six leases reviewed. For all properties other than the Defence Plazas in Sydney and Melbourne, the annual rent increase is 3 per cent over the term of the lease. The lease for the Hydrographic Office, Wollongong also provides for a mid-term review to market. For all leases, if an option period is exercised, rent is reviewed to market from the commencement of the option period.⁴⁰

2.26 In the case of the Defence Plaza properties, where the sale process was managed by Finance, the leases provide for both percentage increases to rent and adjustments to market rental rates. In even years, those leases provide for a rental increase to the greater of 3 per cent or the movement in the Consumer Price Index for that region in the previous year. In odd years, those leases provide for a market rent review with rent not to fall below the base rent set at commencement of the lease. The lease terms effectively provide for a biannual review to market, with an interim 3 per cent increase.

2.27 In respect of the rent review process for the two Defence Plaza properties, AVO has advised ANAO that:

Industry practice for rent review processes for commercial office properties in the Sydney and Melbourne CBDs would normally provide for biannual review to market, without a guaranteed increase during that period. The interim 3 per cent increase provided for in these leases is essentially a guaranteed prepayment of 3 per cent on the market review for the following year.

³⁸ The adjustment of the cash rate target by 10 basis points is provided for in the schedule on interest arrangements included in the 'Agreement for the Provision of Central Banking and Related Services' between the Commonwealth of Australia and the RBA dated 30 June 2004.

³⁹ The breakeven point for the ADC property was reported as occurring during Year 14 in ANAO Audit Report No.1 2004–05, *Sale and Leaseback of the Australian Defence College Weston Creek*. The analysis in that audit was based on calculations using annual rental payments, and a Treasury note rate and Treasury Bond rate as at the date of execution of the sale contract. In this report calculations were based on monthly rental payments, the RBA cash rate target and the Treasury Bond rate effective on execution of the lease.

⁴⁰ This lease condition ensures that the option periods are not included in the assessment of total lease commitments for determination of the classification of the lease as finance or operating.

Table 2.1**Financial analysis of leaseback arrangements and investment of sale proceeds at point of sale and leaseback (GST exclusive)**

Property	Initial lease term Years	Invested proceeds ^a \$m	Rental commitments ^b \$m	Financial outcome \$m	Payback period Years
Defence Plaza, Sydney	10	139	136	3	OLT ^c
Defence Plaza, Melbourne	10	64	66	(2)	10
Hydrographic Office, Wollongong	10	12	16	(4)	7
DNSDC Moorebank	10	321	202	119	OLT ^c
Campbell Park Offices, ACT	20	286	336	(50)	16
ADC Weston Creek, ACT	20	71	95	(24)	15
Notes: (a) Invested proceeds are net sale proceeds invested for the term of the lease at the 10 Year Treasury bond rate at the point of sale. (b) Rental commitments are based on the opportunity cost of rental payments paid monthly in advance. The opportunity cost is the interest forgone on Government cash reserves held in the Official Public Account (the RBA cash rate at the point of sale less 10 basis points). (c) Outside initial lease term.					

Source: ANAO analysis based on Defence and Finance data.

2.28 Finance advised ANAO in March 2005 that the rent review mechanism in the leases for the Defence Plaza properties 'is not uncommon in the commercial office market' and were based on a standard form lease acceptable to Defence and provided by its legal advisors. Finance further advised that 'the 'ratchet clause' in the Defence Plaza leases actually permits rents to fall back to year one levels, which is potentially favourable to the lessee in a falling market'. ANAO notes this applies in years where rent reviews are to market.

2.29 Adjustments to annual rent impact on the likely breakeven point for those sale and leaseback transactions. Two years into the lease terms, the rent had increased by a total of 23 per cent from the commencing rental for the Defence Plaza Sydney, and by a total of 43 per cent for the Defence Plaza Melbourne.

2.30 These increases resulted from a first year rental increase of 3 per cent, a second year rent review to market and, in the case of the Melbourne property, a redefinition of the area leased. The rental increase specific to the market rent review process from that payable in the previous year was \$1.7 million (19 per cent) for the Defence Plaza Sydney property and \$1.4 million (33 per cent) for the Defence Plaza Melbourne.⁴¹ The increase in the amount of area leased by Defence at the Defence Plaza Melbourne property, effective from 1 July 2003, resulted in a further 4 per cent increase in rental payments for the property.

2.31 Applying the total increases to the breakeven analysis performed by ANAO reduces the estimated breakeven point for Defence Plaza Sydney to year 10 and Defence Plaza Melbourne to year 8. Therefore, the significant rent increases only two years into the lease terms could result in a potential negative financial return to the Government within the remaining lease term for both properties.

Funding of lease commitments

2.32 The FMA Regulations, the Defence Procurement Policy Manual and the Defence CEIs require the spending of public monies to be supported by an approved expenditure proposal, an approved procurement process and approval to incur liabilities arising from the procurement process.

Commitment approval

2.33 A procurement process involves Defence entering into commitments arising from the procurement activity. For a sale and leaseback transaction, prior to executing a lease an authorised Defence official is required to approve the expenditure that will become payable under the lease on execution. The procurement approver should be satisfied that the procurement method is an efficient and effective means of achieving value for money. The liability approver in Defence authorises the commitment to financial obligations imposed by the lease over the lease term.

⁴¹ The documentation supporting the rent review process for the Defence Plaza Melbourne required legal advice to be sought on the interpretation of lease terms and conditions supporting the review process. The legal advice was not applied in the rent review process for the Defence Plaza Sydney lease, despite the leases comprising the same terms and conditions.

2.34 During the audit ANAO inquired as to the form the FMA Reg 9 approval took for entering into lease commitments resulting from sale and leaseback transactions. Approval was not obtained for the financial obligations imposed by the lease over the lease term for the transactions to lease the six properties subject to audit review. The liabilities arising from these leases range from 10 to 20 years and include commitments such as rental payments, statutory outgoings, repair and maintenance activity, and utility charges.⁴²

2.35 Defence advised ANAO that at the time the sale and leaseback disposals occurred consideration of the lease arrangements and sign off by authorised officers was taken to include FMA Act considerations and approvals. Defence further advised in May 2005 that:

The disposals process now includes a project director 'compliance checklist' that highlights statutory approvals required for procurement and disposal, and includes reference to the Chief Executive Instruction (Finance) and the Defence Reference Book 47 (Delegations) as well as reference to the relevant section of the FMA Act and the FMA Regulations. Process flow diagrams have also been developed for the disposal process (one each for open market sales and Priority Sales) to provide guidance on the issues that need to be considered. More detailed instructions are being developed and will be promulgated in the near future.

Budget supplementation

2.36 For some properties sold and leased back by Defence, the Government approval for the inclusion of the properties in the annual property sale program also provided for supplementation of annual rental and statutory charges payable under the leases. However, this was not the case for the Defence Plaza properties. The Government approval for the sale and leaseback of Defence property, as part of the 2000–01 Budget process, was specific in relation to those properties for which supplementation would be provided and did not include the Defence Plaza properties. Where supplementation was approved, Defence was supplemented in anticipation of those property sales occurring in the year for which the sale was approved. However, in a number of cases the property sales were deferred or cancelled resulting in a requirement for Defence to pay back the supplementation received.

2.37 Reconciliations had not been performed on supplementation received by Defence in 2001–02 and 2002–03 for leaseback properties, to ensure supplementation covered only actual rental commitments that became payable in the year and statutory charges incurred. Defence and Finance records

⁴² The sale documents for the Defence Plaza properties state that Defence had certified to Finance that an authorised Defence official had approved the expenditure that would become payable under those leases, in accordance with FMA Regulation 9. However, ANAO did not evidence the approval documentation.

indicate that some funding was returned in 2001–02 and 2002–03. Defence advised ANAO in March 2005 that the somewhat ad hoc funding arrangements, in relation to the sale and leaseback program, that existed prior to the development of the 2003–04 Portfolio Budget Statements, have been replaced by a formalised process.

2.38 A reconciliation and repayment in relation to funding for Defence sale and leaseback transactions was undertaken as part of the 2003–04 Budget process. The Government agreed in April 2003 that Defence would receive supplementation for costs associated with additional leasebacks as leases were concluded. The reconciliation of supplementation received by Defence was undertaken against the actual timing of the sales, and resulted in a return of uncommitted operating funds from 2003–04 for properties not yet sold and a new funding baseline for future years.⁴³ Included in that reconciliation was funding in respect of the two Defence Plaza properties. Defence advised ANAO in March 2005 that it considered that inclusion to indicate ‘at least in principle agreement’ to funding it received in prior years and that it used to partially cover lease costs for those two properties.

⁴³ Defence advised the ANAO in January 2005 that it is now standard practice to conduct a reconciliation at budget milestones.

3. Lease Management

This chapter examines the framework for the management of long-term property leases; reviews the contractual arrangements for the management of outsourced property management services; and identifies the expenditure incurred against these leases.

Lease management framework

3.1 A critical aspect of lease management is the identification of the responsibilities of each party to a lease. In Defence, the need to have respective responsibilities of each party clearly defined is heightened by the involvement of numerous contractors in the delivery of services to meet its lease obligations.

3.2 DPS has responsibility for managing Defence's leasing of property and property management activities and has outsourced the provision of that service via the Property Services Contract. When Defence identifies a need to lease a property, the process of entering into an expenditure lease is managed by the Property Management Contractor (the Contractor). However, in the case of leases resulting from a sale and leaseback transaction, the process of entering into the lease was managed by the area responsible for the property sale.

3.3 The commitments for which Defence has retained responsibility under those particular leases has resulted in lease commitments that fall outside the scope of services provided under the Property Services Contract. That is, leases resulting from sale and leaseback present a greater range of commitments to be managed than other Defence expenditure leases.

3.4 Depending on the allocation of responsibilities under the lease with the property owners, Defence's lease management responsibilities for these leases can cover:

- rental payments and periodic rent review;
- insurance and security arrangements;
- building and building services maintenance, including grounds maintenance;
- alterations, extensions or upgrade works;
- domestic services, including cleaning, catering and waste disposal; and
- compliance with statutory requirements, including those relating to occupational health and safety, and energy management.

3.5 Management of these various lease responsibilities is spread across a number of areas within Defence, with some of the services provided in-house and some outsourced. Contact with the property owners, management of rent review processes, and the payment of rental and other charges payable under

expenditure leases is outsourced through the Property Services Contract, which is managed by DPS.

3.6 DPS and Director Facilities Operations provide policy guidance to CSIG Regional Offices⁴⁴ who are in turn responsible for the local management of the Defence Estate, including for repair and maintenance and minor works. Property repair and maintenance services are outsourced through regionally based contracts, generally Comprehensive Maintenance Contracts (CMCs). Defence's obligations to repair and maintain building services, plant and equipment for the leases reviewed are met through the services provided under the CMCs. Additional property services are outsourced through Garrison Support Contracts also managed by CSIG Regional Offices. Services relevant to the leases subject to audit and provided by Garrison Support Contracts include cleaning, grounds maintenance and security. CSIG is currently undertaking a rolling re-tender process across its twelve Regional Offices for the competitive selection of both repair and maintenance and garrison support property services.

3.7 The supply and payment arrangements for electricity and gas to Defence properties, both owned and leased-back, is managed by the Directorate of Logistics and Energy Services within NOD. Defence has negotiated large-scale contracts for the procurement of energy for the whole of the Defence Estate.

3.8 ANAO considers that a useful tool for Defence management of long-term leases resulting from sale and leaseback transactions would be a detailed schedule of commitments assumed by Defence under the leases, and a listing of the area in Defence responsible for managing each of those commitments. The schedule could also cover the management of funding for lease commitments and lease payments to assist in the transparency of budgeted and actual costs associated with the occupancy of these leased properties.

Recommendation No.1

3.9 ANAO recommends that, to assist in the management of lease commitments resulting from sale and leaseback transactions and the identification of the costs of occupancy, Defence develop a detailed schedule of commitments assumed under those leases and the responsibilities for the commitments.

Defence response

3.10 Agreed.

⁴⁴ Regional offices relevant to the six properties subject to audit are Corporate Services Infrastructure – Sydney Central, Sydney West/South, ACT & Southern NSW, and Southern Victoria.

Outsourced services

3.11 Defence has contracted out the management of property services to its current service provider continuously since the commencement of an initial contract on 1 April 1998.⁴⁵ That contract was not competitively tendered in the market and was for an original term of two years, with options for two one-year extensions. Defence exercised both options, and further extended the term to allow tenders to be called for a new contract. Consequently, that initial contract ran from 1 April 1998 through to 30 June 2003. The provision of property management services was put to competitive tender in 2002–03 and a new contract commenced in 1 July 2003.

3.12 The contract covers management of property owned by Defence (both occupied and leased out by Defence) and property leased by Defence, and is for an initial term of four years with options for extensions of up to a further four years.

Tender process

3.13 The current Property Services Contract was awarded via a two-stage tender process, which involved a Request For Tender (RFT) to applicants short-listed from an initial Invitation To Register (ITR) interest for the provision of services. Three firms were invited to submit tenders in response to an RFT, one of which was the existing Contractor. The contract was awarded to the incumbent on the basis of technical capacity to deliver the services, the price offered and an assessed low contract compliance risk.

3.14 ANAO assessed that the tender process, conducted in 2003, was effectively managed. Features of the tender process included:

- drafting of the terms, conditions and performance arrangements for the contract by Defence's legal representative;
- regional staff input to the development of the scope of services to form the basis of RFT documentation;
- approval of the tender evaluation plan outlining evaluation processes and policies, membership and responsibilities of the evaluation panel and negotiation team prior to the release of the RFT;

⁴⁵ ANAO Report No.58 2001–02 *Defence Property Management* reported at page 56:

The contract began in April 1998, after the management firm's purchase in 1997 of Australian Property Group (APG), the former Government property management agency which previously managed the services. Before the sale of the APG, Defence had been planning to call for tenders for the provision of property services. However, the preparations lapsed pending the sale outcome. Before the agreement with APG expired, Defence arranged that the new owner would continue the property services, initially for 12 months, to allow Defence to assess its performance.

- assessment of tenders against mandatory criteria specified in the RFT;
- engagement of legal, financial and probity advisers for the tender process, each providing sign-offs of tender evaluation and negotiation reports; and
- documentation supporting a fair and open process, with adherence to provisions for confidentiality and documentation of communication with tenderers.

3.15 The contract included a transition-in period from 15 April 2003 to 30 June 2003 and full service commenced on 1 July 2003. At the time of audit fieldwork, the Contractor's achievement of all transition tasks was not complete. A component of the Management Information System milestone task, involving the development of an interface between the Defence Estate Management System (DEMS)⁴⁶ and the Contractor's lease data, was yet to be achieved. Defence advised ANAO that development of the interface is now scheduled to commence in March/April 2005, and that the data in that upgrade will align with the contractor's maintenance strategy and scheduling.

Expenditure lease services

3.16 The component of the services provided by the Contractor and the management of the services reviewed in the audit relate to expenditure leases, where Defence is the lessee of the property.⁴⁷ At the time the contract was executed, Defence had 354 expenditure leases.⁴⁸ Exclusive services provided by the Contractor for these leases include financial management and regulatory compliance, including the management of risk and compliance with lease obligations. For leased office accommodation, Defence retains responsibility for environmental management, minor works, energy consumption and management, and occupancy health and safety. The contracted services do not differentiate between leases resulting from sale and leaseback transactions and other expenditure leases.

⁴⁶ DEMS is an electronic information management system that provides CSIG Regional Offices with a common system to manage facilities maintenance.

⁴⁷ The Contract provides for the Contractor to deliver the following services:

- transition-in services, covered by a specific fee;
- exclusive services, covered by the contracted management fee;
- non-exclusive services, subject to contracted rates; and
- sub-contracted services, subject to reimbursement by Defence.

⁴⁸ As at June 2004, 352 expenditure leases were listed in the Defence lease register, of which approximately 37 per cent were expenditure leases with periods of 10 years or greater.

Financial management

3.17 Legal advice obtained by ANAO on the contractual arrangements under the previous contract for property management services identified that the financial arrangements in place for the Contractor, acting as agent for Defence, to hold rent due by Defence did not accord with the requirements of the FMA Act. The FMA Act requires public money in the custody, or under the control of any person acting for or on behalf of the Commonwealth, to be accounted for in an Official Bank Account until paid to third parties. In ANAO Audit Report No.58 2001–02, *Defence Property Management*, ANAO recommended that Defence ensure that financial arrangements with the Contractor comply with the FMA Act.

3.18 The legal adviser engaged by Defence during the re-tendering of the Property Services Contract indicated that money paid by Defence to the Contractor to meet lease payments due to third parties was public money under the FMA Act. Legal advice provided to Defence in September 2002 stated that the ‘only totally risk-free option would be for the FMA delegate in Defence to open an official account and make payments from it on the advice of the Contractor’.

3.19 In October 2002, approval was sought from the Head of Infrastructure Division for the release of the RFT for property management services. The minute requesting approval noted that financial management issues arising from the interpretation of the FMA Act were in the process of being resolved with Finance, through the Chief Finance Officer (CFO) Group in Defence and that a final position would be reached during the tender period.

3.20 In April 2003, the CFO Group recommended that the proposed contract specify that the Contractor bank the public money into a non-official account, based on advice from Finance. Changes made to the draft contract on 11 April 2003 required the Contractor to operate its own account for payment of expenditure.

3.21 Shortly prior to the execution of the Property Services Contract the CFO Group advised that, as a result of more recent discussions with Finance, arrangements for Defence to pay commitments for rent and other outgoings into an account operated by the Contractor for subsequent payment to creditors would in fact be inconsistent with the application of the FMA Act. However, the contract executed between Defence and the Contractor on 15 April 2003 reflected the initial financial arrangements agreed to on 11 April 2003. That is, providing for the Contractor to transact payments for expenditure lease commitments through its own account.

3.22 On 17 June 2003, an Official Bank Account was established for expenditure lease payments due to property owners.⁴⁹ The arrangements for the operation of that account required the Contractor to notify Defence of the amount due for each expenditure lease, and Defence to credit the Official Bank Account with that amount to enable the Contractor to satisfy the lease commitments. Rental payments have been processed in accordance with the provisions of the FMA Act since August 2003.

3.23 A Deed of Variation, relating to the financial arrangements in the Property Services Contract, was not executed until mid-December 2004 to reflect the actual process implemented.

3.24 The FMA Act requires that an official may not make a payment of public money except as authorised by a valid drawing right. Following audit enquiry, a drawing right was executed for this Official Bank Account on 31 January 2005 authorising the Contractor to make payments from the account.

Performance management

3.25 The current Property Services Contract provides for linkages between Contractor's performance, and assessed against KPIs, and the payment of the management fee. The contract value for the exclusive services provided under the contract includes a 'fee at risk' component based on performance. Eligibility for that component can be adjusted at year end based on an assessment of Contractor performance against KPIs. Performance found to be below specified standards at the year end assessment would require moneys to be returned to Defence. A further annual 'reward' may become payable under the contract subject to eligibility for all of the 'fee at risk' components for the year, and satisfactory results of an annual assessment of customer satisfaction.

3.26 Defence manages and monitors performance of the Contractor primarily through the conduct of quarterly national meetings of the National Service Control Group and monthly regional meetings of Regional Relationship Management Groups. The monthly meetings conducted in each region provide for the monitoring and management of the performance of the Contractor within that region. The meetings are chaired by Defence and address performance, property activity and issues raised in an electronic register maintained by the Contractor.⁵⁰ Executive summaries and KPIs

⁴⁹ The official bank account is titled the 'Department of Defence Official Departmental Property Management Payments Account'.

⁵⁰ Personnel from DPS and the CSIG Regional Offices have access to the register via e-premisys, a website provided by the Contractor. e-premisys also allows electronic access to minutes from monthly and quarterly meetings, critical dates, the contract and supporting contract documents such as the Business Plan, and lease documents.

reported at the regional meetings are tabled at the quarterly national meeting, thereby providing upward communication of Contractor performance.

3.27 While the new contract and Business Plan provide very detailed criteria for the assessment of performance against contracted services, in practice, monthly Contractor performance reporting is based on only eleven general Performance Measures supporting the KPIs.⁵¹ These are the same performance measures adopted for the risk and reward assessment conducted at the end of each year. The benefit of the definition of performance measures down to a task level is therefore diminished by the lack of reporting on that basis.

3.28 The Contractor is required to have a formal performance management system that evaluates performance against Minimum Performance Standards (MPSs) and that aligns with, and is complementary to, Defences' systems. The contract provides for Defence access to the Contractor's performance management system to verify the accuracy of those measures. The contract also provides for performance measurement to be undertaken by Defence against KPIs by way of: random spot checks and audits of process and documentation; direct evidence of compliance and quality; and, ongoing customer feedback and six monthly customer satisfaction surveys.

3.29 The contract states that Defence will conduct random spot checks of the Contractor's performance for a large number of tasks, with a rolling yearly program to be developed each year. Defence has not developed an annual program for spot checks and ANAO did not evidence the conduct of either spot checks or audits of Contractor documentation, systems or services by Defence.

3.30 Defence advised ANAO in January 2005 that:

- the Contract Manager has inspected the Contractor's facilities including the Contractor's central storage of leases and certificates of title;
- the Contract Manager has monitored contract performance and the relationship between Defence and the Contractor through attendance at regional relationship meetings in most regions; and
- a program of rolling audits of Contractor documentation can be put in place.

3.31 The contract requires a customer satisfaction survey to be conducted by Defence every six months. The 2003–04 Business Plan specified that the surveys be conducted in November 2003 and March 2004. Defence has conducted two surveys since the commencement of the contract, in February

⁵¹ Two of the Performance Measures supporting the KPIs are measured annually.

and July 2004. Survey questions addressed the timeliness and responsiveness of Contractor services (exclusive and non-exclusive) and provided the opportunity for respondents to comment on any area of service.⁵²

3.32 The surveys are one of the mechanisms used to determine Contractor eligibility for incentive payment arrangements. The MPS for customer satisfaction is identified in the contract as 65 per cent. However, neither the contract nor the 2003–04 Business Plan prescribe how the customer satisfaction score from the surveys will be determined for use in the ‘fee at risk’ assessment. That is, how the results from the two surveys would be aggregated to determine a single percentage figure representing customer satisfaction for the year.

3.33 To clarify and expand upon the details provided for in the contract and the Business Plan, Defence and the Contractor resolved that the Contractor’s score would be based on the average of certain scores for satisfaction with the services, in addition to the scores for overall satisfaction with Contractor performance from the two surveys. Defence advised ANAO that the reason for applying this methodology was to provide a more balanced outcome for both parties. This methodology provided a result of 76 per cent for customer satisfaction for 2003–04 thereby meeting the MPS.

3.34 Review of the survey and its methodology was identified as a task to be jointly undertaken by Defence and the Contractor early in 2005. Defence advised in March 2005 that this review will be extended to include development of an assessment methodology for the ‘fee-at-risk’ component.

3.35 The annual review of Contractor performance for 2003–04, required to determine the Contractor’s eligibility to retain the ‘fee at risk’ component of the management fee paid throughout the year and a reward payment, has not been finalised by Defence.

Lease costs

3.36 The CPPs require that, to encourage efficient, effective and transparent decision-making and accountability, the cost of leased property should be fully reported by the using agency.⁵³ In an earlier audit, ANAO found that Defence did not report the costs of property use in accordance with the CPPs and that there was no authoritative system for recording information about the Defence Estate portfolio.⁵⁴

⁵² The surveys were developed by a consultant under the joint direction of Defence and the Contractor. Survey respondents included staff from DPS Central Office, the Property Disposals Task Force and the CSIG Regional Offices.

⁵³ Commonwealth Property Principle 4.

⁵⁴ ANAO Audit Report No.58 2001–02, *Defence Property Management*.

3.37 The capturing of property costs has improved such that Defence was able to extract property operating cost information for the six leased properties examined in the audit. The costs of occupying property are maintained across the various areas in Defence responsible for the management for the lease commitments. Repair and maintenance costs, deriving from services outsourced through CMCs, were obtained from CSIG Regional Offices. Additional property services, include cleaning, grounds maintenance and security are outsourced through Garrison Support Contracts. These costs were also obtained from CSIG Regional Offices. The cost of utilities is captured centrally by the Directorate of Logistics and Energy Services within NOD. Ongoing expenses for each property, including rent and other expenses are collated centrally within DPS.

3.38 The costs of occupying the six sale and leaseback properties in 2003–04 and provided to ANAO are shown in Table 3.1 and totalled \$63.93 million of which rental payments amounted to \$46.36 million.

3.39 With the exception of costs processed through the Property Services Contract, ANAO did not review the specific details of the expenses contributing to operating costs. However, categories of expenses for each property were examined and determined to be consistent with the commitments for which Defence is responsible under each lease.

3.40 Lease payments processed through the Property Services Contract are centrally managed by DPS on the basis of monthly invoices issued by the Contractor, detailing rent and other non-rent expenses that Defence is liable to pay under the leases. Rent, representing 73 per cent of operating costs incurred under the leases in 2003–04, was reviewed by ANAO and determined to be consistent with lease terms and conditions for all leases including the rent review provisions.⁵⁵

3.41 The monthly invoices provide a limited amount of detail on the types of non-rent expenses, which vary between the leases. The invoice consolidates all payments owing from expenditure leases, from which DPS extracts those relating to sale and leaseback properties. ANAO reviewed the details of the invoiced payments made for the six sale and leaseback properties in 2003–04 and found that payments of material amounts against the six leases were consistent with lease obligations.⁵⁶

⁵⁵ Rent also comprised 54 per cent of all payments processed through the Contractor in 2003–04.

⁵⁶ In 2003–04, actual outgoing expenses were reconciled with estimated amounts at the end of the year for those leases requiring such a reconciliation. The reconciliations were conducted by the owners who provided the assessment to the Contractor.

Table 3.1**Property operating costs incurred in 2003–04**

Properties	Utilities	CMCs ^a	Garrison Support Contracts	Property Services Contract	
				Rent	Other expenses ^b
	\$m	\$m	\$m	\$m	\$m
Defence Plaza, Sydney	0.17	0.42	0.72	11.65	0.45
Defence Plaza, Melbourne	0.23	0.13	0.54	6.54	0.57
Hydrographic Office, Wollongong	0.08	0.01	0.07	1.22	N/A ^c
Campbell Park Offices, ACT	0.93	1.16	2.39	8.98	0.40
DNSDC, Moorebank ^d	2.05	1.56	2.30	15.52	0.76
ADC Weston Creek, ACT	0.26	0.28	1.83	2.45	0.26
Sub-total	3.72	3.56	7.85	46.36	2.44
TOTAL				\$63.93	
Notes:					
(a)	A component of CMC costs was pro-rated on the basis of the volume of equipment per property as regional CMC payment arrangements do not allow for exact apportioning of costs on a property basis.				
(b)	Other expenses are those that Defence is responsible for under the leases and may include outgoings, statutory charges, air conditioning costs and rental determination fees.				
(c)	Defence has no obligations for outgoings under the Hydrographic Office, Wollongong lease.				
(d)	For DNSDC Moorebank, the costs of utilities and Garrison Support are indicative, as costs apply to the whole of the Moorebank site, some of which is still owned by Defence. Costs included in this Table have been apportioned on the basis of the DNSDC portion of the Moorebank site.				

Source: ANAO compilation of figures provided by Defence.

3.42 As part of the assessment of invoiced amounts, ANAO examined supporting documentation to determine the basis for material transactions. That documentation had to be sourced from the Contractor by Defence. Defence advised that it only requests supporting information from the Contractor to verify transactions on an exception basis. Defence advised ANAO in January 2005 that 'DPS will further review adequacy of detail of monthly invoices and supporting information and can put in place a process for periodic audit of non-rent expense supporting documentation and liaise with the contractor of the detail to be provided on invoices'.

3.43 ANAO also verified that from August 2003 to July 2004, Defence effectively processed lease payments through the Property Services Contractor in a timely manner each month, and in accordance with contractual obligations.

Benchmarking costs

3.44 The 2003–04 Business Plan for the provision of property management services provides for the Defence property portfolio to be benchmarked against comparable properties within the client base of the property management services contractor (the Contractor). To achieve this, the Contractor has established a benchmark partnership to measure standard rental, outgoings, energy and repair and maintenance costs. Defence documentation indicates these benchmarking activities have progressed slowly and Defence has suggested the Contractor access other industry benchmarks for the operating costs of accommodation. ANAO considers the establishment of benchmarks for property operating costs would serve as a useful comparator for the costs of operating leased property by Defence.

3.45 Defence advised ANAO in January 2005 that some work has been undertaken in developing benchmarks for the level of maintenance funding required and that, based upon a range of industry benchmarks, it considers that approximately 2.42 per cent of the gross value of the Defence Estate is appropriate. Defence also advised that product costing work being undertaken within CSIG's Corporate Management Branch may be useful for internal benchmarking of property operating costs.

4. Commitment Management

This chapter examines the basis for and management of lease terms and conditions for properties sold and leased back by Defence.

Background

4.1 Major lease terms and conditions were approved in advance of the properties being presented to the market for sale. These define what is actually being sold. The value of the property is closely linked to the terms and conditions that underpin the lease, including the term of the lease, the commencing rental, and rent review arrangements.

4.2 The approved purchasers of the six properties examined in this audit were all essentially institutional purchasers or investment companies.⁵⁷ The features of the leases that made them appealing to long-term investors and structured finance groups included:

- a net rent lease, where the tenant takes responsibility for all or a proportion of the owner's periodic outgoings, including land tax and rates;
- an income stream underwritten by the Government with Defence as tenant;
- guaranteed rental increases over the terms: three of the leases provide for annual increases of 3 per cent; one lease provides for annual increases of 3 per cent excepting the fifth year which is to the greater of market or the rent for the previous year; and two leases that provide for increases in even years to the greater of 3 per cent or the movement in the Consumer Price Index for that city, and adjustment in odd years to market rates; and
- preservation of the capital value of the properties given the Government commitment to the leases for a minimum of 10 years, and with options for further terms.

4.3 Five of the six property leases reviewed in the audit have been classified by Defence as operating leases for accounting purposes. Subsequent to the sale process, the lease for ADC Weston Creek was reclassified as a finance lease in the reporting of Defence's financial position in the 2003–04 Defence Annual Report.

⁵⁷ The initial purchasers were: ISPT Pty Limited; Swelbet Pty Limited; Abacus Nominee Services Pty Limited; GE Capital (Beldon) Pty Limited; Westpac Funds Management Limited; and Strategic Property Holdings No3 Pty Limited.

4.4 Accounting advice received by Defence in November 2002 indicated that a 15 year leaseback arrangement of the DNSDC Moorebank building would result in classification as a finance lease, while a leaseback arrangement of 10 years for both the land and building would result in the lease being assessed as an operating lease.

4.5 Defence records for the sale and leaseback of DNSDC Moorebank indicate that the users of that property required guaranteed use of the site for at least 20 years. The recommendation of the commercial adviser to the sales team, for the lease period to be set at 10 years to maximise the commercial opportunities presented through the site, was not considered acceptable from a user perspective. The Defence Minute approving the lease terms and conditions had an annotation requiring the term of the lease to be cleared by the users of the property. ANAO notes that user access to a longer term has been provided through the condition in the lease for the owner to grant Defence a further term if Defence gives the required notice.

4.6 Warehousing, distribution and maintenance functions performed at the DNSDC Moorebank site have been contracted out by Defence via the 'Provision of Defence Integrated Distribution Services (DIDS) throughout Australia' contract (DIDS Contract).⁵⁸ It was necessary to align the term for the leaseback of the property with the contract term for the outsourced provision of services at the site (as the DIDS Contract involved the licencing of the facilities at DNSDC Moorebank). DNSDC Moorebank is a mandated facility under the DIDS Contract and Defence is required to provide the site to the contractor rent free for the contract term.⁵⁹

Commonwealth National Lease

4.7 The CNL, developed by the Australian Government Solicitor (AGS), provides a benchmark for the acquisition by lease of commercial office

⁵⁸ The DIDS Contract was signed on 18 December 2003. The transition period was staggered from an effective date of 31 January 2004 across the various Defence sites. The contractor assumed full responsibility for service delivery at the DNSDC Moorebank site from 29 October 2004. The contract commencement date, following completion of transition at all sites, is 26 November 2004 and the contract term of eight years plus two one year options commences from that date. The leaseback of the property is for a period of 10 years, commencing 26 March 2003 with an option to renew for two further periods of five years. The lease provides flexibility to Defence in providing first option on the extension of the lease period.

⁵⁹ Defence was advised by the Australian Heritage Commission on 16 April 2003 that DNSDC had been nominated for possible entry in the Register of the National Estate. The private sector owner is not bound by the obligations placed on the Commonwealth under the current legislation. However, as Defence is leasing the property it has obligations under the *Australian Heritage Commission Act 1975*. Section 30 of that Act requires Defence to avoid actions that would impact on the heritage value of the property and to refer actions that may to the Commission. The property has post and beam storage buildings dating from World War 2. In May 2003 Defence undertook to prepare a conservation management plan detailing a conservation policy for the site. The DNSDC site was placed on the Commonwealth Heritage List on 22 June 2004.

accommodation for Government agencies.⁶⁰ The CNL has been designed to produce a balanced allocation of risk between the owner and tenant. Defence has developed a standard lease based on the CNL. The standard lease applies to the lease of office accommodation by Defence.

4.8 The Contractor providing property management services is required to process new lease documentation for approval by Defence, including instructing solicitors in the preparation of lease documentation where the standard lease does not apply. However the leases resulting from sale and leaseback transactions fell outside of this arrangement having been negotiated by the sales team responsible for marketing the properties.⁶¹ For this reason, the terms and conditions of the leases resulting from sale and leaseback transactions vary from standard lease terms usual in expenditure leases negotiated by Defence. In particular, net leases were put in place where rental is payable in addition to other property charges.

4.9 The main feature of the CNL is that it proposes that leases be based on gross leases, allowing financial commitments under a lease to be readily forecast by the tenant. The CNL does not prescribe a rent review process, but provides for parties to agree to rent review dates.

4.10 The main differences between terms and conditions of the CNL and the lease for commercial office accommodation at Campbell Park Offices are provided at Table 4.1.

4.11 Defence has assumed an extensive range of commitments under the Campbell Park lease.⁶² The most significant of these is the requirement for Defence to maintain building services,⁶³ plant and equipment. Under the CNL the only obligation for repair and maintenance prescribed for the tenant relates to maintenance of the premises to a good and tenantable condition, having regard to the condition of the premises at the beginning of the lease, with no obligation to repair damage arising from fair wear and tear. Under the CNL, the owner's responsibilities for maintenance and repair work extends to

⁶⁰ The earliest version of the CNL was developed in the early 1990s, and was known as the National Tenant's Lease. A revised version of the CNL was produced by the AGS in August 2002.

⁶¹ The leases for the Defence Plaza properties in Sydney and Melbourne were developed by Finance, and the leases for the remaining properties selected for ANAO review were developed by Defence.

⁶² Insurance premiums, grounds maintenance, cleaning of areas external to the Premises and the payment of utilities required to operate building services are owner obligations under the CNL. These are Defence responsibilities under the lease for Campbell Park Offices. The same lease also requires Defence to give between 12 and 24 months notice prior to expiry to exercise the option to renew the lease, whereas the CNL only requires the tenant to give three months notice. In the leases for Campbell Park Offices, and the Defence Plazas Sydney and Melbourne, Defence also assumes the owner responsibility under the CNL of paying for water rates.

⁶³ Building services are those that are central to the operation of a building and typically include air conditioning, lift, fire, electrical, communication and hydraulic services.

anything falling outside of the tenant's responsibilities, including the building services and structure.

Table 4.1

Comparison of the lease for Campbell Park Offices and the CNL

Lease condition	Lease for Campbell Park Offices	Commonwealth National Lease
Rent	Net rent, with Defence committed to meet all or a proportion of outgoings, including statutory charges and service charges.	Gross rent, including all outgoings except for tenancy cleaning, electricity, water and gas.
Obligation to repair and maintain	Defence to maintain and repair building services.	Tenant to keep premises in good and tenable repair only, and has no obligation to maintain and repair building services and structure.
Utilities costs (electricity, gas and water)	Defence is to pay all costs with respect to utilities consumed at the premises including building services.	Tenant to pay for consumption costs of utilities consumed on the premises excluding building services.
Insurance	The owner is to insure and Defence is to reimburse owner for premiums.	Owner to insure and pay for premiums. Tenant only to reimburse additional premiums it incurs.
Fitness for occupation and use	Standards not specified.	To comply with building standards specified in the lease and industry standards applicable at commencement of lease.
Note: The CNL defines premises as the area extending from the interior face of all walls, doors, windows and from the surface of the floor to the underside of the building. The definition of premises in the lease for Campbell Park Offices is whole of property (land and building).		

Source: ANAO analysis of the lease for Campbell Park Offices and the CNL developed by the AGS (March 2002).

4.12 The leases for DNSDC Moorebank and ADC Weston Creek, while not office property, also vary significantly from the CNL. The leases impose additional commitments that, when compared to the CNL, would normally have passed to the property owner. In addition to assuming repair and

maintenance obligations, in the case of the DNSDC Moorebank property Defence has also assumed responsibility for environmental remediation over the lease term.

4.13 The Contract for the Sale of Land for DNSDC Moorebank notes that the Government does not warrant that the property complies with all environmental laws and precludes the purchaser from making any claim for compensation in relation to matters arising from that disclosure. However, the lease for DNSDC Moorebank includes an obligation for Defence to 'remediate the land to a standard suitable for on-going commercial/industrial use and so that no significant contamination is migrating from the site'. This contractual responsibility has Defence carrying a liability for the term of the lease.

4.14 The due diligence phase of a property sale of that size would generally include an environmental survey allowing for the identification of contamination exposure on the property and the quantum of remediation work required. The issue of contamination on the DNSDC Moorebank property was removed as an impediment to sale, both in terms of the time required to conduct the surveys and the potential impact on the sale price.⁶⁴ Generally the sale price of a property would reflect the remediation effort involved. However, in this case the sale price has not been affected by potential contamination as Defence is carrying the ongoing liability. This liability was not reported in the tender evaluation report.

4.15 Where the onus for rectification work on environmental issues passes to the purchaser with the sale of land, legislation generally requires environmental surveys to be conducted on the land prior to sale. As Defence retained responsibility for remediation full disclosure of the nature of any contamination was not required. Net proceeds from sale and leaseback of the property did not reflect a provision for the environmental warranty. Defence advised ANAO in January 2005 that revised procedures ensure that future proposals address all cost issues in the context of value for money.

Repair and maintenance

4.16 The Defence Plaza properties and the Hydrographic Office, Wollongong were sold in 2000–01 with gross leases, where the owner is responsible for ongoing repair and maintenance activity for the buildings and plant and equipment. The properties sold and leased back by Defence in subsequent years were sold with net leases. A significant commitment retained

⁶⁴ Defence advised ANAO that a preliminary assessment of the environmental condition of the site was undertaken prior to the sale of the property and this was made available to tenderers. Defence also advised that some remediation works have subsequently been completed for occupational, health and safety purposes.

by Defence in those net leases is the repair and maintenance obligation.⁶⁵ This commitment differentiates those leases from other expenditure leases on Defence's lease register. It is not common practice for Defence to assume repair and maintenance obligations in any other expenditure leases negotiated by Defence.

4.17 Defence effects the responsibilities it has under the leases for repair and maintenance through maintenance contracts with external service providers. While property ownership has transferred to the private sector in these sale and leaseback transactions, arrangements for the management of the maintenance for the properties remains unchanged with that transfer. Prior to sale and leaseback, repair and maintenance for properties in the Defence Estate, whether owned or leased, was outsourced and delivered by regional CMCs and Garrison Support Contracts.

4.18 Defence property sale documentation indicates that Defence favoured maintaining responsibility for on-going maintenance of properties after sale to maintain control over the buildings and facilities. Defence also considered that the CMCs offered competitive rates for maintenance activity having been let through competitive tendering processes.

4.19 As the repair and maintenance contracts provide outsourced services to the Defence estate at large, only a small component of the services provided under these contracts relate to the properties subject to leaseback arrangements. Services provided through CMC include day-to-day maintenance of the premises for the Defence Plaza, Sydney and Melbourne properties and the Hydrographic Office, Wollongong and additional repair and maintenance obligations for DNSDC Moorebank, ADC Weston Creek and Campbell Park. Garrison Support services relevant to Defence's obligations under the leases include cleaning, grounds maintenance and security.

4.20 The contracts for the provision of repair and maintenance of plant and equipment are performance-based, allowing contractors to apply a risk based approach to their whole-of-life maintenance responsibilities. There is an increased risk that only minimal regular preventative maintenance on fixed plant and equipment would be undertaken in such contracts. Defence advised ANAO in March 2005 that contractors are bound to deliver services outlined in a maintenance plan agreed with Defence within the first six months of contract commencement and, in the event of failure to deliver services in accordance with the scheduled maintenance plan, are responsible for any defect that may arise.

⁶⁵ Defence's commitments in the leases for Campbell Park, DNSDC Moorebank and ADC Weston Creek cover the maintenance and repair of building, plant and equipment, and building services. The only responsibilities transferred to the owner are for structural repair and replacement of plant and equipment.

4.21 Management of lease terms and conditions relating to repair and maintenance for leased back properties is complicated by the need to determine the respective responsibilities of Defence and property owners, and the requirement for contact with property owners to occur through the provider of outsourced property management services.

4.22 The provider of property repair and maintenance services through CMCs, operates a call centre in each CSIG Regional Office to record notification of faults and to progress action to address those faults. The repair and maintenance call centre operator uses the Defence Estate Management System (DEMS) to record requests for repair and maintenance and to assign faults to the responsible party in order for it to be remediated. Repair and maintenance activity that is a Defence responsibility is conducted by the CMC contractor on Defence's behalf. Repair and maintenance activity that is the responsibility of the property owner is referred by the call centre to the Contractor for property services.⁶⁶

4.23 While property management services have been contracted out to a firm with expertise in that field, interpretation of responsibilities for repair and maintenance obligations under leases is handled by the call centres operated under the CMC contracts. ANAO was informed by CSIG staff that information available on DEMS has not been entirely effective in assisting in the ready identification of lease related responsibilities at the regional level. Defence advised ANAO that work to populate DEMS with information to inform the call centre operator, based on data imported from the Contractor for property management services, is scheduled to commence in March/April 2005.

4.24 In January 2005, Defence advised that as an interim measure, the Contractor for property management services has provided CMCs with details of the respective lease responsibilities of the owner and Defence to assist in the referral process. Defence is reliant on the call centres operated by the CMCs to correctly identify owner responsibilities and to refer such matters to the Contractor providing property management services. Therefore the Contractor with the expertise in lease management is not involved in the assessment.

4.25 ANAO was informed by CSIG staff that the need to seek further clarification from the property management Contractor on the respective obligations of Defence and the owner often delayed the repair process. Unlike contractual arrangements between Defence and its outsourced provider of repair and maintenance services, the leases reviewed do not address agreed turnaround times for completion of such activities where repair and

⁶⁶ The Contractor for property services is responsible for following up the fault with the owner and advising the CMC call centre once the fault has been rectified, who in turn notifies the tenant that the fault has been addressed.

maintenance obligations reside with the owner.⁶⁷ Defence advised ANAO in January 2005 that the absence of turnaround times in the leases has been noted for future improvement.

4.26 In the case of Campbell Park Offices, Defence has initiated a process for the inclusion in the annual program of work for facilities operations an upgrade to the heating and cooling plant and distribution system. The upgrade makes provision for Defence to recover costs from the owner should any of the building's plant and equipment servicing the heating and cooling require replacement. Whilst this is in accordance with lease obligations for Defence to repair and maintain, and the owner to replace building services, plant and equipment, the lease also provides for Defence to request the owner to carry out upgrade works. ANAO did not cite any evidence that Defence had initiated correspondence with the owner to clarify whether the upgrade would involve repair or replacement activity, before commencing upgrade works itself.⁶⁸

Recommendation No.2

4.27 ANAO recommends that, to ensure that property lease obligations retained by Defence for repair and maintenance are managed consistently and effectively:

- (a) sufficient information on lease terms and conditions be provided through the Defence Estate Management System for access by outsourced providers of repair and maintenance services to determine the respective responsibilities of Defence and the property owner; and
- (b) future leases negotiated by Defence include performance standards for owner obligations for building services, plant and equipment and structure.

Defence response

4.28 Agreed. Preparation to include the information referred to in (a) in the Defence Estate Management System is already underway.

⁶⁷ ANAO notes that the leases for commercial office property specify turn-around times for the owner to complete faults relating to building services, and recourse where those times are not met.

⁶⁸ Defence advised ANAO in January 2005 that while the work has been bid for it was not funded in the 2005–06 Facilities Operations Program and that no work has commenced. Defence further advised that it is awaiting the results of a study commissioned to identify the nature of the air-conditioning and heating problems, and depending on the outcome of that study it may negotiate with the building owner for replacement.

Security

4.29 In the leases examined in the audit, property owners are required to provide Defence 'quiet enjoyment' of the properties. The leases include right of entry clauses that provide the owner access to the property upon giving reasonable notice to Defence. The leases also provide for Defence to notify the owner of its requirements relating to security and confidentiality at its absolute discretion. The owner is required to comply with those requirements, thereby providing Defence with adequate control over security of the properties. Defence advised ANAO that, where appropriate, details are provided at a Regional level through the property services Contractor.

4.30 Essentially, the security arrangements in place at the properties sold and leased back by Defence would not have changed with the passing of ownership of the properties to the private sector, and the lease terms and conditions provide for revised arrangements to be put in place if required by Defence.

4.31 Defence's security requirements may provide for Defence to deny the owner access to the property. However, if the owner is denied access and this inhibits the owner from complying with its obligations under the lease, the lease for all properties (except DNSDC Moorebank) provide for the owner to be released from those obligations and for Defence to assume responsibility for those obligations. If the owner incurs additional costs from being denied access to the property, Defence is required to reimburse those costs and to compensate for any loss or damage suffered from not complying with its obligations. Defence has advised that no claims have been received for additional costs resulting from owners being denied access to properties.

4.32 The lease for the Defence Plaza property in Melbourne of June 2001 was found to not adequately cater for Defence's security interests at that site, requiring a variation to the lease. A Deed of Variation of Lease for an extension to the space leased by Defence, and effective from 1 July 2003, was executed on 13 February 2004. A renegotiation of the areas covered by the lease was required as the designation of space as 'common areas' on the ground floor of the property provided for public access and posed a security risk to Defence. The variation revised the definition of the space leased by Defence to cover an additional 727 square metres of space, and resulted in a 4 per cent increase in rental payments for the property.

Insurance

4.33 In general, terms and conditions of the six leases reviewed in the audit require the owner to insure the buildings and to insure against public risk, with the insurance to be in the joint names of the owner and the tenant.

Defence, as tenant, is required to indemnify the owner against negligent acts or omissions by Defence in connection with its use of the property.

4.34 The leases for the Defence Plazas properties in Sydney and Melbourne and the Hydrographic Office, Wollongong are consistent with the CNL and Defence's standard expenditure lease. They only require Defence to reimburse the owner for additional insurance premiums resulting from Defence being named as an interested party to the insurance. In contrast, the leases for Campbell Park Offices, DNSDC Moorebank and ADC Weston Creek require Defence to reimburse the owner in full for the insurance premiums.

4.35 Defence had not effectively managed lease terms and conditions relating to insurance for properties sold and leased back by Defence. Defence had not proactively managed the annual renewal of insurance policies for these properties to ensure that the coverage remained consistent with the terms and conditions of the leases. Defence could not readily respond to audit inquiry on the conformance of insurance coverage for the properties with lease terms and conditions. Neither Defence, nor its contracted property service provider, held copies of current insurance policies to allow such an assessment to be made. Also, at the time of audit review, the Commonwealth was listed as an interested party on the Certificate of Currency for only one of the six insurance policies taken out by the property owners. In the case of the DNSDC Moorebank property, a lower premium for the current insurance policy, over that paid in the previous year, had not been assessed to determine whether a more competitive rate had been negotiated, or whether the risk coverage had been changed.

4.36 In response to audit inquiry, the Contractor for property services advised that no significant issues have arisen between the property owners and Defence in relation to insurance matters for the six leases reviewed by ANAO.

Indemnities

4.37 The six leases each include an indemnity clause⁶⁹ requiring Defence to indemnify the property owner against certain occurrences. The standard clause in the CNL requires a tenant to indemnify the owner from and against all actions, claims, demands, losses, damages, costs and expenses for which the owner becomes liable, essentially arising from negligent acts or omissions of the tenant in connection with their use of the premises.

⁶⁹ Finance Circular No. 1997/06, *Guidelines for Issuing Indemnities, Guarantees, and Letters of Comfort* defines an indemnity as 'a legally binding promise whereby one party undertakes to accept the risk of loss or damage another may suffer'.

4.38 Defence has assumed additional contingent liabilities relating to indemnities in two of the leases reviewed. The owner of the Hydrographic Office Wollongong is indemnified against liabilities suffered or incurred by the owner in respect of issues arising from Environmental Law, or claims in respect of contamination of the property, arising from any activity of Defence. The indemnity applies whether or not the liability arose prior to or after the commencement of the lease, and arises from any act or omission, whether negligent or otherwise, on the part of Defence.

4.39 The lease for the DNSDC Moorebank property includes a clause that:

releases the Lessor from all claims in respect of any death of, or injury to, any person, and any accident or damage to property of whatever kind which arise from the Lessee's use and occupancy of the Premises (except to the extent that it is contributed to by the Lessor's negligence).

4.40 Such claims would normally be included as usual risks in relation to insurance coverage required to be taken out by the owner. In the DNSDC Moorebank lease, the owner 'must keep insured against public risk in respect of all claims for loss, injury or damage to any person or property arising out of the ownership of the Premises'. The distinction under this lease is whether the claim arises from use and occupancy of the premises, or from ownership of the property.

4.41 The leases for all properties except the DNSDC Moorebank also require Defence to indemnify the owner against all charges for water consumption, electricity, garbage and waste disposal and other services consumed or used. For the Defence Plazas and Hydrographic Office, this excludes charges for building services. However, for the Campbell Park Offices and ADC Weston Creek properties, Defence also indemnifies the owner against charges for building services. Indemnities for such service charges are not included in the CNL.

4.42 Indemnity insurance provided by Defence is effected through an insurance policy with Comcover. Indemnities granted by Defence under these leases expose the Government to contingent liabilities. The indemnities included in the leases resulting from sale and leaseback transactions are uncapped. Details of material, remote or unquantifiable contingencies are required to be disclosed separately in the notes to an agency's financial statements. The Defence CEI on indemnities requires a register of issued indemnities to be maintained. Following audit enquiry Defence has now recognised the indemnity liabilities arising from these six property leases through their inclusion in the central register.

4.43 Indemnities are a risk transference mechanism which can result in the Government accepting risk and the contracting party experiencing reduced risk. There is no documentation of risk assessments associated with the

indemnities included in the leases, or of referral to Defence's legal section to determine whether risks covered by those indemnities would be included in the general indemnity insurance held by Defence with Comcover. Further, there is no evidence that the indemnities provided in the leases were taken into account when assessing value for money of the sale and leaseback transactions. These procedures should precede the execution of the lease and the inclusion of the liabilities in the indemnities register.⁷⁰

4.44 The sale process should ensure that risks assumed by the Government, through exposure from the issue of indemnities in the leases, are effectively approved and managed. To address issues such as this, Defence advised ANAO in January 2005 that:

the Property Disposals Task Force has aligned disposal processes with the Government approved Asset Development Model. Detailed procedures have been drafted and are nearing completion. This includes process flow charts and a project officer's compliance 'check list' to ensure all appropriate approvals are obtained.

Recommendation No.3

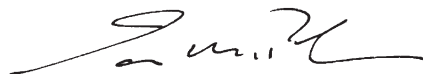
4.45 ANAO recommends that, to better manage lease commitments for insurance for properties sold and leased back, Defence:

- (a) routinely perform a risk assessment of the insurance commitments proposed under the leases and quantify the exposures;
- (b) assess the compliance of the current insurance policies with executed lease terms and conditions; and
- (c) implement procedures to better manage exposures arising from indemnities provided to the owners of the properties.

Defence response

4.46 Agreed.

Canberra ACT
25 May 2005



Ian McPhee
Auditor-General

⁷⁰ ANAO Audit Report No.27 2002–03, *Management of Commonwealth Guarantees, Warranties, Indemnities and Letters of Comfort* concluded that there was scope for agencies reviewed to improve management of these instruments, particularly in areas of record keeping, effective risk management, and control of exposures.

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