The Auditor-General

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Performance Audit

Commonwealth Estate Property Sales

Department of Finance and Administration

Australian National Audit Office

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Australian National
Audit Office

Canberra ACT
1 August 2001

Dear Madam President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit in the Department of Finance and Administration in accordance with the authority contained in the *Auditor-General Act 1997.* I present this report of this audit, and the accompanying brochure, to the Parliament. The report is titled *Commonwealth Estate Property Sales.*

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

P. J. Barrett
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

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Abbreviations/Glossary

AGS	Australian Government Solicitor
AGSO	Australian Geological Survey Office
ANAO	Australian National Audit Office
AVO	Australian Valuation Office
BRG	Business Review Group
CAPM	Capital Asset Pricing Model
CBD	Central Business District
CEIs	Chief Executive's Instructions
CEO	Chief Executive Officer
CPC	Commonwealth Property Committee
CPI	Consumer Price Index
CPPs	Commonwealth Property Principles
CSIRO	Commonwealth Science and Industrial Research Organisation
CTL	Commonwealth Tenants' Lease
DAS	Department of Administrative Services
DFAT	Department of Foreign Affairs and Trade
DISR	Department of Industry, Science and Resources
DOF	Department of Finance
DOFA	Department of Finance and Administration
DPG	Domestic Property Group
DPTF	Domestic Property Task Force
Finance	Department of Finance and Administration
FMA Act	*Financial Management and Accountability Act 1997*
FMA Regs	Financial Management and Accountability Regulations
GBE	Government Business Enterprise
Guidelines	*Commonwealth Procurement Guidelines*
HOA	Heads Of Agreement
IRR	Internal Rate of Return

MoU	Memorandum of Understanding
NLA	Net Lettable Area
NPV	Net Present Value
OASITO	Office of Asset Sales and IT Outsourcing
Office Estate	Commercial Office Estate
RFT	Request For Tender
SOCC	Social Opportunity Cost of Capital
SP&I Estate	Special Purpose and Industrial Estate
TEC	Tender Evaluation Committee
TEP	Tender Evaluation Plan
TER	Tender Evaluation Report
Treasury	Department of the Treasury
1996 Deed	1996 Deed of Standing Order
1999 Deed	1999 Deed of Standing Order

Summary and Recommendations

Summary

Background

1. This audit focuses on the sale of properties from that portion of the domestic property estate managed by the Department of Finance and Administration (Finance) and identified for sale via a three year divestment strategy of the Commercial Office Estate by Government in April 1997. Prior to commencing the divestment program in 1997–98, the domestic estate comprised 790 properties valued at $2.33 billion. The Commercial Office Estate (Office Estate) was the largest component valued at $1.254 billion; followed by the Special Purpose and Industrial (SP&I) Estate ($694 million); and Public Interest Estate ($385 million).[1]

2. In the 1996–97 Budget context, the Government took a number of decisions which significantly affected the management of Commonwealth owned and leased property. A set of Commonwealth Property Principles (CPPs) was endorsed by the Government in July 1996, setting the framework for decisions to retain or dispose of Commonwealth property.[2] The CPPs were the subject of considerable debate in mid-1996 between the then Department of Administrative Services (DAS) and the then Department of Finance (DOF). The debate related to the hurdle rate of return to be used in assessing sell/retain decisions for individual properties. The hurdle rate proposed by DOF was adopted by Government.

3. A Commonwealth Property Committee (CPC) was established to implement the CPPs. The Government decided that all properties that did not meet the criteria laid down in the CPPs should not be retained in Commonwealth ownership. The primary task of the CPC was to provide independent advice to the responsible Minister on the whole-of-government management and co-ordination of the strategy for the divestment of property no longer required to be owned by the Commonwealth.

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1 The SP&I Estate comprises non-office accommodation for specific government programs with many properties having specialised uses, including, for example, laboratory buildings for CSIRO, law courts, museums and meteorological stations. The Public Interest Estate is a miscellaneous collection of a range of properties including heritage properties, residential cottages constructed for migrant miners and war workers during World War II, and a variety of radio receiving and transmitting sites utilised by the National Transmission Agency.

2 The 1986 Commonwealth Property Disposals Policy also provides that property having no alternate efficient use is to be sold on the open market at full market value.

4. In endorsing the CPPs, the Government considered that, generally, the Commonwealth could make better use of its scarce capital than property investment. Australian National Audit Office (ANAO) notes that this position is effected by the adoption in the CPPs of a hurdle rate of return for property that overwhelmingly favoured the divestment of property over retention. The CPPs state that the Commonwealth should own property where the long-term yield rate exceeds the social opportunity cost of capital or where it is in the public interest to do so. A hurdle rate of 14 to 15 per cent (nominal) was to apply to decisions about retention or divestment of property, and the full social opportunity cost of capital was to apply to decisions on new property development.

5. Review of the domestic estate by the CPC[3] commenced during 1996–97 with the assessment of individual properties within the Office Estate against the CPPs. The divestment strategy recommended by the CPC was endorsed by the Government in April 1997 and involved the divestment of 57 (later 59)[4] Office Estate properties over a three-year period.[5] The Government was advised that the sale of the properties would increase net budget outlays in the longer term as future rental payments to the private sector grow. The aggregate book value of the properties identified for divestment was $1.05 billion as at 30 June 1996. The book values were the basis on which the rates of return were initially calculated.[6]

6. In implementing the divestment program, Finance relied extensively on the private sector to manage the sales process. This included the use of consultants for property sales advice, legal advice, property marketing, and sales preparation including property due diligence. The divestment process was co-ordinated by the Divestment Unit within the Property Group of Finance.

Audit approach

7. The audit approach involved reviewing the advice provided to Ministers that established the property sales program and the administration of the sales program, including consideration of whether the sale offers for property with existing leases were in accord with relevant policies and represented value for money to the Commonwealth.

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3 The CPC was established for two years and ceased after the issue of its final report in October 1998.

4 Following the sub-division of a regional property and the inclusion of an additional property found to share plant with an adjacent building included for sale in the packages.

5 A further 15 properties were identified for future examination. Twelve of those properties were located in the ACT, and one each in the NT, WA and Queensland.

6 Divestment of the SP&I Estate commenced in 1999–2000 when the bulk of the material Office Estate sales workload had been completed.

The audit objective was to review the efficiency and effectiveness of the management of the property sales process by Finance. In particular, the audit sought to assess the effectiveness of the management of the sales process for selected property sales, including the extent to which the Government's sale objectives have been achieved; review the long-term sale and leaseback arrangements for selected divested properties and whether they adequately protect the Commonwealth's interests; and identify principles of sound administrative practice to facilitate improved administrative arrangements for future property sales.

8. The Office Estate properties reviewed in the audit represented 43 per cent of the total value of the properties recommended by the CPC for divestment. Total sales realised almost $1 billion for the three year divestment program. The sale of the Australian Geological Survey Office (AGSO) Headquarters property was also reviewed as the most material property in the SP&I Estate divested in 1999–2000, selling in May 2000 for $152.4 million. The audit focused particularly on properties sold with long-term leaseback arrangements to the Commonwealth.

Overall audit conclusions

9. Total gross proceeds from the sale of Office Estate properties included in the three year divestment program were $983 million as at April 2001, with three of the 59 properties remaining unsold. The sales program was successful in that total proceeds to April 2001 have exceeded revenue targets by $130 million or 15 per cent.[7]

10. Fifteen high value properties were grouped into six packages of properties to be sold via international tender. The requirement to sell Packages 1 to 4 (Packages 1–4) in 1997–98, and Packages 5 and 6 (Packages 5&6) in 1998–99 was met and, in both years, the gross proceeds from sale exceeded the latest market valuations for those packages. One-quarter of the total properties recommended for divestment were packaged, and realised 85 per cent of the total sale proceeds. The packaging strategy was successful in that it realised the sale of all properties in the required timeframes. Most material properties reviewed in the audit were sold at, or above, the final market valuation obtained at the time of sale.[8]

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7 The total proceeds to April 2001 are some $69 million below the 30 June 1996 aggregated book value of $1 052 million. Finance advised ANAO that the book values were largely of historical relevance as they were generally based on hypothetical ten year leases and associated rents, were profoundly affected by rent reductions and shortened lease terms negotiated by agencies, and did not reflect the large vacancies in Government-owned buildings.

8 One of the six packages of properties and ten individual property sales (23 per cent) were concluded at sale prices below the current market valuation. Finance advised ANAO that the overall variation below market of nine of the individual properties was less than 4.2 per cent, and the other property was approved by the Minister for Finance and Administration as a concessional priority sale as per the Commonwealth Property Disposals Policy.

11. Finance advised ANAO in April 2001 that its role was to implement a property divestment program endorsed by Ministers and that it was not charged with the role of protecting the overall interest of the Commonwealth. ANAO considers that, given the administrative division of responsibility and accountability, Finance is the only agency in a position to ensure that property divestment is consistent with the CPPs and to make an informed judgment as to whether a property sale and leaseback transaction represents efficient and effective use of Commonwealth resources at the time of the transaction.

12. The approver of a Commonwealth property sale effectively endorses both the sale of the property and the execution of leases for the property with the proposed purchaser. An inquiry process necessarily involves Commonwealth officers in making comparisons of costs and benefits of alternative options. In the property sale and long-term leaseback transactions reviewed by ANAO[9], it was not apparent that a systematic process of inquiry, as required under the Financial Management and Accountability Regulations (FMA Regs) and the *Commonwealth Procurement Guidelines* (Guidelines), was conducted by Finance prior to executing the sale contract and leasing arrangements with the purchasers. ANAO's legal advice is that if there is a conflict between the efficient and effective use of public money and the requirements of the CPPs it would be prudent to seek guidance or reconsideration of the policy. In circumstances where a proposed sale of Commonwealth property does not appear to represent value for money at the time of the final sale, it would be good administrative practice for Finance to inform Minister(s) of the inquiries undertaken and seek their consent before proceeding with the sale.

Divestment strategy

13. By applying the hurdle rate of return of 15 per cent in the CPPs to the selection of properties for sale, it would be unusual for the Commonwealth to continue to own property.

14. In October 1999, Finance commissioned a consultant to determine the economic rate of return for Commonwealth property ownership. The consultant used the Capital Asset Pricing Model (CAPM) and reported that the most likely risk return rate should be around 10 per cent per annum, although there was considered to be uncertainty surrounding this estimate. The consultant provided a further report in October 2000

[9] AGSO Headquarters, Symonston ACT; RG Casey Building, Barton ACT; Discovery House, Woden ACT.

suggesting that, for CAPM purposes, the relative risk measure (beta) of property investment can be estimated at approximately one half (0.5) and suggested a central estimate of the market required return to property of approximately 9 per cent. The consultant noted there was considerable uncertainty about this estimate and suggested a wide range for the property hurdle return to be appropriate, with the upper bound at approximately 11 per cent.

15. Finance is now considering a further consultant's report of December 2000 in regard to the appropriate hurdle rate of return in the CPPs. ANAO considers that the application of the average equity beta of the market (that is, 1) proposed in that report does not accord with the specific risks attributable to property. The risk measurement approach adopted by the consulting firm that reported to Finance in October 1999 and October 2000 (using CAPM) is consistent with project specific risk rates for property. This latter approach accords with that recommended by the then DOF in the 1991 *Handbook of Cost-Benefit Analysis* for the setting of discount rates. That publication advocated that the best option in choosing a discount rate is to develop a project-specific rate using the CAPM framework. A property with security of tenure to the Commonwealth in the form of a non-cancellable lease over a long period represents a low risk and the criteria used for the hold/sell decision should reflect that risk profile.

16. The use of a hurdle rate of return that is too high would result in a sub-optimal investment outcome and financial loss to the Commonwealth when combined with long-term leaseback arrangements. ANAO's analysis indicates that, if a hurdle rate of 10 per cent was applied (see paragraph 14), only eight of the 59 properties would have been scheduled for divestment, with a book value of $232 million; and applying a hurdle rate of 12 per cent would have resulted in divestment of only 23 properties, with a book value of $326 million. In contrast, actually applying a hurdle rate of 15 per cent would have resulted in divestment of virtually all of the property holding, or some 99 per cent ($1 038 million) by value of the property portfolio.

17. In practice, all properties that exceeded the hurdle rate were recommended for divestment, except one property in the Parliamentary Triangle that was retained in the public interest. The documentation made available to ANAO did not allow effective review of the assumptions underpinning the rates of return identified by the CPC for the properties recommended for divestment.

18. During the course of the CPC's review, the book values of the properties were adjusted to take account of market conditions at the time and probable occupancy levels and leasing profiles. The revised assessments prepared by the advisers to the CPC were not revised valuations for divestment but represented potential sale proceeds. The adjustments reduced the value of the properties recommended for divestment by some $200 million, a one-fifth decrease in total value. However, rates of return for the properties were not re-calculated based on these revised assessments, which would have increased the rates of return, thus generally supporting a higher retention of properties in Commonwealth ownership.

19. Finance was aware that tax depreciation was an issue affecting the sale price of properties. However, it did not provide prospective purchasers with schedules of depreciable assets for the properties to be divested, which may have enhanced sale proceeds. The joint advisers to the CPC reported in March 1997 that market testing indicated depreciation schedules should be provided. In June 1998, the real estate agents involved in the sale of Packages 1–4 advised Finance that provision of indicative depreciation schedules would have enhanced sale return. Common commercial practice is to provide depreciation schedules to facilitate financial analysis by investors. In addition, Finance did not obtain advice as to the whole-of-government implications of tax depreciation for sale/leaseback arrangements reviewed in this audit prior to executing contracts.

Sale management

20. The costs of sales were estimated by Finance at $20.6 million, or 2.1 per cent of sale proceeds. The primary components of the cost of sales were payments to sale advisers, sale agents and legal advisers contracted from the private sector. The cost of sales was not maintained against individual properties in packages. Finance advised ANAO that the CPC, after taking advice from industry, considered a cost of sale figure of 3 to 4 per cent to be applicable for these properties. Finance has used this range as guidance throughout the sales program.

21. For the sale of Packages 1–4 in 1997–98, the final evaluation report recommending acceptance of the proposal for the role of sales adviser did not make any conclusions on the fee structures proposed, despite the nearly tenfold range in fees of the short-listed parties from $318 650 based on hourly rates, to a $3.1 million success fee. For Packages 5&6, a non-competitive selection for the role of sales adviser was adopted on the basis of earlier performance in this role in the sale process for Packages 1–4, and the need to complete the sales in the 1998–99 financial year. The fee reduction of $60 000 proposed by the sales adviser was not included in the contract. There is no documentation to support the exclusion of that condition from the contracted terms. The sales adviser informed ANAO in May 2001 that the efficiency dividend was based on the retention of the same sales team within Finance and that: '*between tender and contract documentation the core team was changed and therefore the dividend did not apply.*' The contracted fee was the greater of a monthly retainer of $120 000, or 0.6 per cent of gross sale proceeds plus reimbursement of out-of-pocket expenses. While the selection of the firm was justified on the basis of value for money, with reduced fees anticipated, in the event Finance did not benefit through a reduced fee as the success fee payable on sale proceeds (which was the same as applied for Packages 1–4) exceeded the sum of the monthly retainers.

22. Finance estimated the cost of legal services provided by the legal adviser for the sale of packaged properties to be $3.6 million. The legal adviser informed ANAO in June 2001 that: '[its] *appointment from within the DAS Legal Panel for the property divestments in 1996–97 and 1997–98 were each the result of a further competitive process within the Legal Panel—although further competitive quotation was not required in order for DAS to instruct a panel firm under the DAS Legal Panel Deed 1996–1999*.' The firm offered a discount for fees over a threshold of $900 000 for Packages 5&6 to reflect the experience gained in the earlier sales. The engagement for services was approved on that basis. However, a discounting arrangement was not reflected in contractual documents. Finance advised ANAO that the overall fees for Packages 5&6 increased above $900 000 due to a major change in the scope of works. Finance further advised that, rather than a discount, an arrangement relating to the charging of travel and accommodation expenses previously negotiated would continue instead.

23. A firm was engaged by Finance in November 1999 on a sole source basis to act as the sales adviser in the sale of the AGSO property, with success fees to be based on a sliding scale. Finance agreed to pay the sales adviser a success fee of 0.8 per cent based on a June 1999 market valuation for the property of $90.54 million. Prior to approving this basis for payment, the value of the property was substantially increased by lease terms and conditions put in place for sale of the property. The property was subsequently valued at $135 million and assessed by the sales adviser with a range of values from $145 million to $150 million before sale. It sold for $152.4 million in mid-2000. The firm was paid a fee representing 1.67 per cent of sale proceeds, well above both the success fee of 0.8 per cent based on the $90.54 million valuation, and the 0.6 per cent negotiated with the sales adviser for the packaged properties. Had the success fee been based on the June 1999 pre-lease valuation rate of 0.8 per cent of proceeds, it would have been $1.3 million less than the actual fee paid to the sales adviser for the AGSO sale.

Sale process

24. The criteria for evaluation were included in the Request For Tender (RFT) for properties sold by tender. In the major sales, the criteria were not weighted. There was no scoring of criteria and no quantified risk analyses of the bids. The criterion of primary importance was effectively price. Sales were generally concluded with the highest bidder lodging a conforming bid, or the highest non-conforming bid that was considered commercially acceptable after the clarification process. Each of the lower value property sales reviewed by ANAO at Rockhampton, Bendigo and Wagga Wagga sold for prices well below the valuations used in the initial decision to divest the properties.

25. The successful tender for Package 3 (RG Casey Building and Adelaide Commonwealth Centre) included a condition whereby the purchase price could fall by up to $15 million in the event that interest rates increased. Finance did not obtain advice as to whether the interest rate condition in the successful tender needed to be managed, or how this should be done. Finance retained an open exposure to this risk and, as a result of interest rates increasing, the Commonwealth received $4 million less for the package than the nominal tender price of $221 million.

26. Finance requires that a copy of the contract of sale be signed by the tenderer and lodged with the bid prior to the bid being accepted, but does not routinely conduct financial capability assessments on short-listed tenderers or require bidders to lodge a security with the bid. The selected tenderer for the AGSO property withdrew after advice of selection as preferred bidder by Finance. This resulted in the Commonwealth necessarily accepting a price some $5.6 million less than it would have received had the sale been completed with the preferred tenderer.

Sale and leaseback arrangements

27. The initial rentals paid under the AGSO property, RG Casey Building and Discovery House leases exceeded market values included in the market valuations for sale for those properties, by some 17, 12 and 7 per cent respectively. In May 2001, the Department of Foreign Affairs and Trade advised ANAO that the net lettable area had been re-measured and that the new owner had formally notified the Department that they were seeking a 38 per cent increase in the base rent for the RG Casey Building to $22 723 537.

28. ANAO analyses of the whole-of-lease-term costs for sale and long-term leaseback of property found that they could result in a potential negative financial return to the Commonwealth within the lease period. The AGSO property and RG Casey Building both reach a possible financial break-even point in Year 11 and Discovery House in Year 8, after which the Commonwealth could be paying more in rent than it could receive if it invested the sale proceeds at the Commonwealth Treasury Bond rate.

29. ANAO's legal advice is that a range of the risks of ownership for the AGSO Headquarters has been transferred to AGSO, as the tenant, with only some of the benefits. Finance did not obtain professional advice on the nature of the lease for the AGSO property at the time of lease commitment in order to ensure that the sale and leaseback arrangements would be properly characterised as a property sale rather than a finance transaction. During evaluation of tenders in April 2000, the sales adviser managing the sale assessed the terminal value of the property to be $15 million which essentially reflected that the 20 year lease represented the economic life of the property. After the May 2000 sale, that sales adviser re-assessed the terminal value to $121.5 million in July 2000, based on an economic life of the building of 40 to 50 years. Finance advised ANAO in April 2001 that both the sales adviser for the AGSO property sale and Finance always considered the lease to be an operating lease and that additional professional advice was sought after ANAO raised concerns. ANAO concurred with the Finance position that it was an operating lease for financial statement purposes.

30. To ensure that the Commonwealth's financial position is maximised, the objective in a sale/leaseback property transaction is to negotiate a contract with the preferred bidder that delivers the highest possible positive Net Present Value (NPV). ANAO estimated that the AGSO property sale transaction could result in a negative NPV of $95 million when the net sale proceeds are compared with possible lease payments over the 20 year lease term. The lease commitments include the costs of funding the lease payments, and projected annual rent increases based on historic movements in the CPI (All Groups) for Canberra. The NPV would be negative $49 million based on the minimum lease payments over the 20 year lease. Finance calculations, in advice to the Minister in April 2000, indicated a positive NPV of $43 million.

Improvement opportunities

31. Sale management better practices identified in this audit could also be applied to future Commonwealth property sales, including forthcoming major sales at CSIRO and in the Defence portfolio.[10] Good administrative practice for an agency disposing of Commonwealth property with a long-term leaseback arrangement requires a number of inquiries to be made by the approving officer including:

- determining whether or not the property should be sold in accordance with the relevant policy;
- if a decision is made that the relevant property falls within the policy, establishing the full market value for the property;[11]
- the 'full market value' should recognise whether there are special conditions attaching to the property, and the price should reflect the fact that the property is sold with a secure Commonwealth lease-back arrangement; and
- the decision to sell the property with a lease back to the Commonwealth should also involve specific consideration of the application of FMA Regs 9 and 13, together with those inquiries required under the *Commonwealth Procurement Guidelines*. This should be undertaken by the relevant Commonwealth officer responsible for the sale of the property irrespective of whether or not a similar inquiry had been undertaken by the Commonwealth agency in occupation of the property under the initial notional lease.

32. ANAO made seven recommendations identifying opportunities for improvement in the management and ongoing implementation of the property divestment process. Specific areas for improvement include:

- review of the hurdle rate of return to be applied in the sell/hold decision for property;
- management of contractual arrangements with external consultants;
- tender evaluation, including evaluation against Request for Tender criteria, and management of sale completion risk; and
- assessment of value for money during tender evaluation in sale and long-term leaseback transactions to the Commonwealth.

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10 Programs of property sales were included in the 2001–02 Budget statements for CSIRO and the Defence Portfolio. CSIRO property sales are estimated at $59 million for the two year period 2001–03, and Defence property sales at $1 billion for the four year period 2001–02 to 2004–05.

11 Where the property contemplated for sale is in a unique area where there is no competitive market, or is a specialised facility, and where it is offered to the market with a long-term leaseback arrangement to the Commonwealth, it would be good practice to obtain a number of independent valuations to ascertain the appropriate price for the property.

Department of Finance and Administration response

33. All seven ANAO recommendations were disagreed by Finance. Finance noted, in its response to the audit report, that it considers '*the concepts that underpin the report are fundamentally flawed.*' While there are sometimes good reasons for differences of opinion, it is helpful if the basis for these differences is evident. In this case Finance did not elaborate on its comments in its response, other than the comments provided against each recommendation.

34. It is of some concern to ANAO that the Department did not agree with any of the ANAO recommendations which were framed to achieve improved administrative practices for future property sales. While audit reports primarily provide assurance to the Parliament on administrative processes and the effectiveness and efficiency of the use of public money, a further significant value of those reports is promoting or encouraging improved administrative processes to secure better outcomes for the Commonwealth in the future. Where agencies have demonstrably taken, or are in the process of taking, action that would result in improvements in administration and/or value for money, such action is usually noted in an audit report. Recommendations for such action are only included where it is not clear that action has taken place and/or is being contemplated.

Recommendations

Set out below are ANAO's recommendations arising from this report. Report paragraph references and abbreviated Finance responses are included here with more detailed responses shown in the body of the report together with the findings.

Recommendation No.1
Para 2.25

ANAO recommends that Finance, in its review of the methodology for deriving the hurdle rate of return in the Commonwealth Property Principles, have regard to including a project specific risk rate for property that accords with the Capital Asset Pricing Model approach outlined in the Department of Finance's 1991 *Handbook of Cost-Benefit Analysis*.

Department of Finance and Administration response: Disagreed.

Recommendation No.2
Para 3.35

ANAO recommends that Finance review, in future property sales, the:

(a) payment of success fees to advisers on current market valuations for assets; and

(b) allocation of responsibility to external advisers for lease negotiations and sale management where success fees are calculated on the total proceeds from sale.

Department of Finance and Administration response: Disagreed.

Recommendation No.3
Para 3.54

ANAO recommends that Finance review all material contractual arrangements with external advisers engaged in the property divestment process to ensure Commonwealth contractual commitments are fully documented and effectively managed.

Department of Finance and Administration response: Disagreed.

Recommendation No.4
Para 4.34

ANAO recommends that, for property sale tenders, Finance:

(a) evaluate the merits of incorporating, as part of the tender evaluation process, appropriate priorities that set out the relative importance attaching to each evaluation criterion; and

(b) document explicit consideration of the extent to which tenders comply with all evaluation criteria identified in the Request For Tender.

Department of Finance and Administration response: Disagreed.

Recommendation No.5
Para 4.51

ANAO recommends that, to provide assurance that the overall interests of the Commonwealth are protected, Finance's approval processes for a property sale and leaseback transaction include the formal consideration of the: Commonwealth Property Disposals Policy; Commonwealth Property Principles; Financial Management and Accountability Act and Regulations; Commonwealth Procurement Guidelines; and the relevant Chief Executive's Instructions.

Department of Finance and Administration response: Disagreed.

Recommendation No.6
Para 4.66

ANAO recommends that, on material property sales, Finance institute improved management practices for completion risk through:

(a) evaluating requiring bidders in a public tender to lodge a security with the bid, such as a deposit, bank guarantee or a parent guarantee; and/or

(b) considering the conduct of financial capability assessments on short-listed tenderers, prior to the selection of the successful tender.

Department of Finance and Administration response: Disagreed.

Recommendation No.7
Para 5.58

ANAO recommends that Finance include an appropriate whole-of-lease assessment of value for money in advice to the delegate for approval on material sale and long-term leaseback transactions to ensure the financial interests of the Commonwealth are protected.

Department of Finance and Administration response: Disagreed.

Audit Findings and Conclusions

1. Introduction

This chapter discusses the background to the property divestment process and the audit approach.

Background

1.1 The ownership and management of the Commonwealth Property Estate is concentrated in the Department of Finance and Administration (Finance) and the Department of Defence. The Property Group of Finance has responsibility for the implementation of the Government's policy in regard to the use of real property for the portfolio of Commonwealth-owned property it manages in Australia and overseas, and one of its main functions has been the oversight of property sales.[12]

1.2 As part of the reform of the Commercial Office Estate it was announced in the 1997–98 Budget that the Commonwealth would divest 57 (later 59) properties over a three-year period.[13] The divestment strategy was formulated by the Commonwealth Property Committee (CPC)[14] and agreed by Ministers in April 1997 (see Chapter 2).[15] Prior to the Government embarking on a major property divestment program the domestic estate had 790 properties estimated to be worth $2.33 billion comprising the Commercial Office Estate (Office Estate) of $1.254 billion; Special Purpose and Industrial (SP&I) Estate of $694 million; and the Public Interest Estate (comprising mainly heritage buildings) of $385 million.[16]

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12 The portfolio of Commonwealth-owned property managed by Finance excludes properties controlled by the Department of Defence, GBEs, and agencies enabled by their legislation to own property.

13 An additional property was included and an existing property was divided into two properties.

14 The CPC is discussed in Chapter 2.

15 A further 15 properties were identified for future examination. Twelve of those properties were located in the ACT, and one each in the NT, WA and Queensland.

16 The SP&I Estate comprises non-office accommodation for specific government programs with many properties having specialised uses, including for example, laboratory buildings for CSIRO, law courts, museums and meteorological stations. The Public Interest Estate is a miscellaneous collection of a range of properties including heritage properties, residential cottages constructed for migrant miners and war workers during World War II, and a variety of radio receiving and transmitting sites utilised by the National Transmission Agency.

1.3 Figure 1.1 shows the movements in the domestic property portfolio managed by Finance over the three years 1997–98 to 1999–2000. In the period July 1997 to June 2000, Finance disposed of 595 properties valued at $1 302 million. The divestment strategy for the Office Estate endorsed by Ministers in April 1997 was expected to result in divestment of approximately $1 billion from the Office Estate.[17] The commercialisation of the SP&I Estate followed the review of the Office Estate, and divestment of those SP&I Estate properties assessed against the Commonwealth Property Principles (CPPs) commenced in 1999–2000, when the bulk of the material Office Estate sales workload had been completed.

Figure 1.1

Movements in Finance domestic property portfolio 1997–98 to 1999–2000

Property estate	*Value 1 July 1997 ($ million)*	*Number of properties*	*Value 30 June 2000 ($ million)*	*Number of properties*	*Increase/ (Decrease) ($ million)*	*Number of properties (Decrease)*
Commercial Office	1254	138	284	29	(970)	(109)
Special Purpose and Industrial	694	167	701	57	7	(110)
Public Interest	385	485	46	109	(339)	(376)
Total	**2333**	**790**	**1031**	**195**	**(1302)**	**(595)**

Source: Divestment Unit of Finance.

1.4 A list of the Office Estate properties included in the three-year divestment program reviewed in this audit is included at Figure 1.2. Total proceeds from sale for sales finalised to April 2001 was $983 million. Some 38 per cent of proceeds ($375 million) were for properties located in the ACT; 28 per cent ($277 million) in New South Wales; 17 per cent ($163 million) in Victoria; 12 per cent ($118 million) in Queensland; 2 per cent ($24 million) in South Australia, and about 1 per cent each ($14.6 million and $9.6 million respectively) in Western Australia and Tasmania.

17 The diverstment strategy resulted from a review of Office Estate properties with a book value of $1 million or more.

1.5 The Office Estate properties reviewed in the audit represented 43 per cent of the total value of the properties recommended by the CPC for divestment. Total sales realised almost $1 billion for the three year divestment program. The Australian Geological Survey Office (AGSO) Headquarters was the most material property in the SP&I Estate divested in 1999–2000 and sold for $152.4 million in May 2000. The audit focused particularly on properties sold with long-term leaseback arrangements to the Commonwealth. Sale management better practices identified in this audit could be applied to future Commonwealth property sales, including forthcoming major sales at CSIRO and in the Defence portfolio. Programs of property sales were included in the 2001–02 Budget statements for CSIRO and the Defence Portfolio. CSIRO property sales are estimated at $59 million for the two year period 2001–03 and Defence property sales at $1 billion for the four year period 2001–02 to 2004–05.

1.6 The CPC considered that success of the divestment program for the Office Estate was dependent on being able to offer properties with legally enforceable leases providing security of rental income over a reasonable period of time. It was recognised that sale prices were dependent on the tenancy positions of those properties, and all properties were to be sold subject to the tenant's residual right of occupancy. This required that properties be offered to the market with legally binding, commercially-oriented leases in place. A new lease document was drafted, titled Commonwealth Tenants' Lease (CTL), structured so that it could be transferred with a Commonwealth property at sale. In December 1996, Ministers endorsed the form of the lease, requiring agencies occupying space in Commonwealth buildings administered by the then Department of Administrative Services (DAS) to commit to leases in that form by mid-February 1997 or be deemed to have committed to such leases for 10 years or the life of any Memorandum of Understanding (MoU) in place.

Figure 1.2

Finance's Office Estate sales by location July 1997 to April 2001 included in the three year divestment program approved in April 1997

State	Property [1]	Sale Price [2] ($m)	State	Property	Sale Price ($m)
ACT	R.G Casey Building Barton	197.0	**SA**	Commonwealth Government Centre Adelaide	20.0
	Edmund Barton Building Barton	59.2		Commonwealth Offices Salisbury	0.9
	Discovery House Woden	30.6		Commonwealth Offices Berri	0.9
	Robert Garran Offices Parkes	22.1		Commonwealth Offices Murray Bridge	0.9
	3–5 National Circuit Barton	21.4		Commonwealth Offices Port Augusta	0.8
	Deakin Offices Deakin	17.3		Commonwealth Offices Port Lincoln	0.7
	Alexander Building Woden	7.8			
			TAS	Commonwealth Government Centre Hobart	8.3
	Albermarle Building Woden	7.5			
	Sirius Building Woden	7.3		Commonwealth Offices Devonport	0.8
	Fishburn House Woden	1.7		Commonwealth Offices Glenorchy	0.5
	Borrowdale House Woden	1.6			
	Naval Combat Systems Centre Fyshwick	1.0	**VIC**	Casselden Place Melbourne	142.1
				231–235 Lyttleton Terrace Bendigo	3.2
				Commonwealth Government Offices Frankston	2.9
NSW	Sydney Central Sydney	137.6			
	Jessie Street Centre Parramatta	113.0		300 Queen Street Melbourne	2.7
	Commonwealth Government Offices Wollongong	9.8		Commonwealth Offices Oakleigh	2.7
	Commonwealth Government Centre Dubbo	3.4		Clarke Street South Melbourne	2.5
	Darlinghurst Comm Offices Darlinghurst	3.2		DSS Cheque Issuing South Melbourne	2.3
	5–7 Short Street Port Macquarie	2.6		DSS Office Newmarket	1.9
	Commonwealth Offices Wagga Wagga	2.5		Commonwealth Offices Sunshine	1.6
	36–38 Raymond Street Bankstown	2.0		6–14 Andrews Avenue Bendigo	1.1
				265 Lyttleton Terrace Bendigo	0.2
	Commonwealth Offices Tweed Heads	1.6	**WA**	ATSIC Regional Offices East Perth	3.8
	Commonwealth Offices Orange	1.5		Commonwealth Offices Fremantle	3.6
QLD	Commonwealth Government Centre Brisbane	96.0		619 Murray Street Perth	2.9
	Stanley Place Townsville	15.7		Yaworroong Wunan Building Kununurra	1.3
	Commonwealth Centre Mackay	2.5		Commonwealth Offices Burswood	1.3
	Commonwealth Centre Rockhampton	2.0		Commonwealth Offices South Hedland	1.0
	West End Offices Brisbane	1.1		Commonwealth Offices Kalgoorlie	0.7
	Commonwealth Offices Bundaberg	0.8			
NT	Jock Nelson Building Alice Springs	1.8		**Total proceeds**	**983.2**[3]

Notes:

1: Three properties remained unsold at April 2001: Commonwealth Offices Woodridge, Queensland; Commonwealth Government Centre Inala, Queensland; and Commonwealth Offices Rosny, Tasmania.

2: Figures have been rounded; total proceeds are expected to be $990 million excluding the AGSO property from the SP&I Estate.

3: The three year divestment program of the Office Estate did not include the 15 properties identified as requiring further examination during the CPC review.

Source: Finance data

Commonwealth Property Principles

1986 Commonwealth Property Disposals Policy

Commonwealth property having no alternative efficient use is to be sold on the open market at full market value. Exceptions to this general policy are:

a) priority sales—made direct to a purchaser without the property having first been offered for sale on the open market. A priority sale may be arranged in certain circumstances.[18]

b) concessional sales—where priority sales are concluded at a price below market value. Such sales require the approval of the Minister for Finance and Administration.[19]

1.7 The policy framework for the retention or divestment of Commonwealth real property comprises a property disposals policy and a set of property 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 alternative efficient use to be sold on the open market. Exceptions to that policy included priority and concessional sales.

1.8 Government policy on the ownership of property is more recently contained in the July 1996 Commonwealth Property Principles (CPPs). The CPPs apply to all Commonwealth property and set the framework within which the Government will take decisions on the need to own or divest property. The CPPs are based on the premise that the Commonwealth should own property only where rates of return on property exceed a set hurdle rate or where it is in the public interest to do so.

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18 (i) Where there is a former owner entitlement as defined under the Lands Acquisition Act—the owner is to be given the right of first refusal at full market value; (ii) where sale to State or local Governments would facilitate other Commonwealth or co-operative policy initiatives or would protect other Commonwealth property interests—sale to be negotiated on the basis of the highest price possible given the intended end use; and (iii) where Commonwealth funded organisations seek special consideration in the disposal of surplus property and have the support of the relevant portfolio Minister—sale to be negotiated on the basis of intended end use.

19 In the case of Commonwealth statutory authorities, the agreement of the relevant portfolio Minister is also required to any concessional sale.

Commonwealth Property Principles—Principle 1

The Commonwealth should own property where the long-term yield rate exceeds the social opportunity cost of capital or where it is otherwise in the public interest to do so.

- Over the medium term, the Department of Finance advises that Commonwealth property projects have been approved with rates of return of 14–15% (nominal). This medium term rate would seem the appropriate figure for decisions about retention or divestment of existing property holdings, taking into account past achievement of those rates of return.
- The full social opportunity cost of capital for the Commonwealth should apply to any new property development. While this will vary over time, the existing rate is much higher than the medium-term property hurdle rate previously used.
- Given the competitive nature of the property market it would be unusual for the long-term yield rate for office and other commercial accommodation requirements to exceed the Government's social opportunity cost of capital (ie generally, the Commonwealth could make better use of its scarce capital than property investment).

1.9 Review of the domestic estate commenced during 1996–97 with the assessment of individual properties within the Office Estate against the hurdle rate. The review focused on properties valued in excess of $1 million and covered 76 properties with a total book value of approximately $1.28 billion as at 30 June 1996. These properties represented 98 per cent of the total book value of the Office Estate administered by the then DAS at that time. That assessment resulted in the Government announcing in the 1997–98 Budget that 57 office properties would be listed for sale over a three year period. The aggregate book value of those properties was $1.05 billion as at 30 June 1996.[20]

1.10 Gross realisation from the sale of these properties was estimated at $852 million. Fourteen of the higher value properties were grouped into six packages to be sold in 1997–98 and 1998–99 and were expected to realise approximately $714 million. The remaining 43 properties were to be sold individually with an expected realisation of $138 million and comprised the smaller regional and metropolitan properties.

1.11 Four properties in the Parliamentary Triangle with heritage buildings entered on the Register of the National Estate were recommended for retention on public interest grounds. The remaining 15 properties were considered to warrant further review, assessed as having major divestment difficulties relating to vacancy rates, condition and location. One property was subsequently included in the first tranche of packaged properties sold in 1997–98[21] and three remained unsold as at April 2001.

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20 The book value figure was based on estimated rental streams and hypothetical lease terms and was not produced for divestment purposes.

21 Fishburn House, Woden, ACT.

Audit approach

1.12 The audit approach involved reviewing the advice provided to Ministers that established the property sales program and the administration of the sales program, including consideration of whether the sale offers for property with existing leases were in accord with relevant policies and represented value for money to the Commonwealth. The audit reviewed the Department's management of the sales process for selected properties[22] in seven case studies covering nine properties (see Figure 1.3). The total value of the property sales considered amounted to $619 million. Six case studies related to Office Estate properties and spanned the three financial years of the divestment program, the various modes of sale, and a range of property locations.[23] The sale of the AGSO Headquarters, from the SP&I Estate, was also reviewed as it was the most material SP&I Estate property sold in 1999–2000, and it provided coverage of all material property sold during the period 1997–98 to 1999–2000 with leaseback arrangements to the Commonwealth exceeding 10 years.

Figure 1.3

Property sales case studies

Property	*Price ($ million)*	*Year of Sale*	*Mode of sale*
Package 3 RG Casey Building—Canberra Adelaide Commonwealth Centre	217.3	1997–98	International Tender
Package 4 Discovery House—Canberra	30.5	1997–98	International Tender
Package 6 Casselden Place—Melbourne Edmund Barton Building—Canberra	201.3	1998–99	International Tender
Rockhampton Commonwealth Centre	2.0	1998–99	Priority Sale
Bendigo Commonwealth Offices	3.19	1999–2000	Direct Sale (passed in at Auction)
Wagga Wagga Commonwealth Offices	2.5	1999–2000	Direct Sale (passed in at Auction)
AGSO Headquarters—Canberra	152.4	1999–2000	International Tender

Source: Finance data.

22 Previous audit reports have also examined property sales, including Audit Report No.20 1996–97, *Selected Commonwealth Property Sales in Portfolio Departments of Veteran's Affairs, Defence and Administrative Services* and Audit Report No.29 1995–96, *Management of the Commercial Estate*.

23 In July 1996, the Government agreed to property asset sales totalling $104.5 million, prior to the CPC report on property divestments. The sale of the 11 properties scheduled for 1996–97 are outside the scope of this audit.

1.13 The objective of the performance audit was to review the efficiency and effectiveness of the management of the Commonwealth Estate Property Sales process by Finance. In particular, the audit sought to: assess the effectiveness of the management of the sales process for selected property sales, including the extent to which the Government's sale objectives have been achieved; review the long-term sale leaseback arrangements for selected divested properties and whether they adequately protect the Commonwealth's interests; and identify principles of sound administrative practice to facilitate improved administrative arrangements for future property sales.

1.14 Audit fieldwork was conducted between April and December 2000. The fieldwork included the review of material maintained by the Divestment Unit of Finance and consultation with various stakeholders in the sale process, including agencies occupying property sold in the divestment program, external consultants engaged by Finance, and prospective purchasers of property. ANAO engaged the Australian Government Solicitor (AGS) to provide advice on legal issues, and the Australian Valuation Office (AVO) to provide advice on valuation issues that arose during the audit. ANAO provided five issues papers to Finance in early March 2001 followed by a discussion paper in late March 2001. The draft Section 19 Report, or relevant extracts, were issued in May 2001 to 16 relevant parties. A revised report was issued to Finance in June 2001 reflecting comments provided to the draft report. A further response was received in July 2001 from Finance.

1.15 The audit was conducted in accordance with ANAO Auditing Standards at a cost to ANAO of $315 000.

2. Divestment Strategy

This chapter discusses the policies and principles governing the divestment of property and their application.

Background

2.1 There has been a trend away from ownership of Commonwealth property over the last quarter of a century. In 1976, the Commonwealth owned 51 per cent of its office space requirements but, by 1996, this had reduced to 34 per cent.[24] In 1995, a Senate Committee conducted an investigation of property management in the Australian Public Service which found serious shortcomings in property management practices[25] and a number of reforms were implemented. A key recommendation was that a central property database be established to give Government a window on the totality of its property holdings. However, six years later there is still no central database covering Commonwealth property holdings.[26]

2.2 In May 1996, a Domestic Property Task Force (DPTF) was set up by the then Minister for Administrative Services to assess market interest in purchasing Commonwealth property with industry invited to make submissions. In August 1996, it reported that the Commonwealth domestic property estate was valued at some $24 billion.[27] It also highlighted that many properties did not meet building and Occupational Health and Safety standards, were poorly maintained, and would require considerable expenditure to refurbish and redevelop them to an acceptable standard for continuing occupation and / or sale.[28] In examining the option of divesting the estate, the DPTF recognised that the initial positive effects on the total budget from selling the properties would expire after seven years assuming a 12 per cent social opportunity cost of capital, with a net increase in outlays of $350 million expected within 10 years.

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24 However, figures on the present ratio were not available.

25 Including a lack of strong focus on real estate investment, inability to achieve occupancy efficiencies and the need for central strategic planning and co-ordination.

26 In May 2001, AVO advised ANAO that it managed, in conjunction with the Australian Estate Management Division of the then DAS, the production of a complete register of Commonwealth property holdings in 1992-93. AVO also advised that: '*The reconstruction of the database, possibly misplaced between 1993 and 1995, to include a Whole of Government Lease Register should be a priority.*'

27 Comprising around $7.1 billion for properties managed by Defence, $13 billion by Statutory Authorities and other exempt organisations, and $3.8 billion by DAS.

28 For example, around 96 per cent of ACT buildings were over 15 years old and required an estimated $400 million to refurbish and redevelop, with ongoing maintenance costs of $25 million annually.

2.3 In June 1996, Ministers agreed that a major review be undertaken of the Commonwealth's strategic interests in the ownership and management of property, and that a plan for the orderly management of the Commonwealth's strategic property interests be prepared with a submission for the disposal over five years of non-strategic properties in the domestic Office Estate.

2.4 The Minister for Finance and the then Minister for Administrative Services agreed in June 1996 to establish a Business Review Group (BRG) to examine the appropriate level of Commonwealth involvement in domestic and overseas property. The BRG was to conduct a study on the Commonwealth domestic and overseas estate to assist Government to establish a considered position regarding the role of property ownership and management in securing public sector efficiency. The BRG was tasked with recommending strategic principles for Commonwealth involvement in domestic and overseas property. The BRG was required to report to the above-mentioned Ministers and comprised three private sector advisers, supported by the then DAS and Department of Finance (DOF) officers. The report of the DPTF was to be considered by the BRG.

Divestment criteria

2.5 In the 1996–97 Budget context, the Government took a number of decisions which significantly affected the management of the Commonwealth Estate of owned and leased property. A set of Commonwealth Property Principles (CPPs) was adopted[29] and a Commonwealth Property Committee (CPC) was established to operate during the implementation of the CPPs.[30] The CPPs were the subject of considerable debate in mid-1996 between the then DAS and DOF. The debate related to the hurdle rate of return to be used in assessing sell/ retain decisions for individual properties. The hurdle rate proposed by DOF in 1996 was adopted by the Government.

2.6 The Government decided that all properties that did not meet the criteria laid down in the CPPs should not be retained in Commonwealth ownership.[31] The CPPs implied that it would be unusual

29 The Principles were developed by the BRG and endorsed by Government on 31 July 1996.

30 The CPC comprised one representative each of the then DOF and DAS and two private sector representatives, from its establishment until October 1997. It reported to the Ministers for Finance and Administrative Services jointly and was serviced by the Domestic Property Group of DAS and two private sector consulting firms appointed as advisers by the CPC.

31 Ministers were required to report on the application of the Principles to portfolio properties in the context of the 1997–98 Budget.

for Commonwealth office property to meet the criteria for continued ownership. The primary task of the CPC was to provide independent advice to the Minister on the 'whole-of-government' management and co-ordination of the strategy for the divestment of property no longer required to be owned by the Commonwealth.

2.7 In endorsing the CPPs, the Government considered that generally the Commonwealth could make better use of its scarce capital than property investment. ANAO notes that this position is effected by the adoption in the CPPs of a hurdle rate of return for property that overwhelmingly favoured the divestment of property over retention. The first Principle states that the Commonwealth should own property where the long-term yield rate exceeds the social opportunity cost of capital[32] or where it is in the public interest to do so. A hurdle rate of 14 to 15 per cent (nominal) was estimated as the appropriate figure for decisions about retention or divestment of property, and the full social opportunity cost of capital was to apply to decisions on new property development. Principle 2 details the public interest considerations to be considered in the decision to own or divest property.

Commonwealth Property Principles—Principle 2

Public interest considerations which may influence the decision as to whether the Commonwealth should own property include circumstances where:

(a) the property has:

- National symbolic significance;
- National security requirements;
- Strategic significance to future government use;
- Highly specialised uses that would significantly inhibit commercial provision;
- Significant heritage and environmental requirements;
- Significant public usage;
- Characteristics such that the nature of the use or development of the property by the Commonwealth would give a potential lessor excessive future negotiation power; and
- Special diplomatic requirements.

(b) there exists clear evidence of market failure. This could include properties such as:

- Small regional offices in isolated locations[33]; and
- Those in markets where there is a predominance of Commonwealth ownership.

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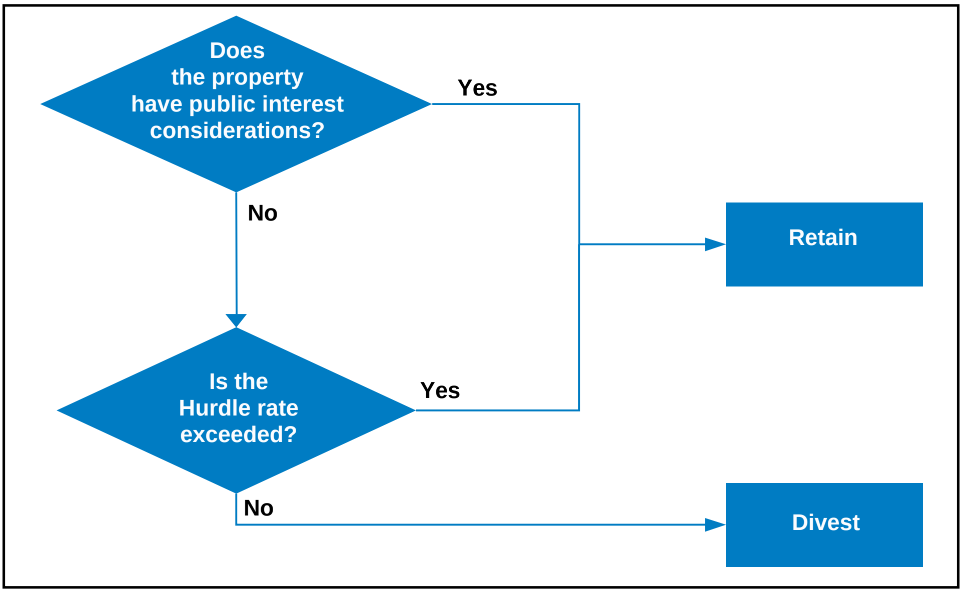
32 The social opportunity cost of capital rate represents the return on the investment elsewhere in the economy which is displaced by the marginal public sector project.

33 Where there would be no other tenants should the property become vacant or where private investors would demand excessive rates of return to recover their investment over the life of the lease.

2.8 Figure 2.1 depicts the decision process for the assessment of property required by the CPPs. The CPPs provide that the Commonwealth should only own property where the long term yield exceeds a hurdle rate of 14 to 15 per cent, or where it is in the public interest to own property.

Figure 2.1

Decision process for retention or divestment of Commonwealth property required by the Commonwealth Property Principles (CPPs)



Source: ANAO analysis of CPPs

Hurdle rate of return

2.9 In the application of the CPPs, 15 per cent has been adopted by the CPC and Finance as the hurdle rate of return that property is required to achieve in order for retention of property to be considered. The *Commonwealth Property Principles Application Guidelines for Agencies* developed by the CPC in January 1997 state that the nominated hurdle rate is currently a rate of return of 14 to 15 per cent, and was derived from experience '*over the medium term*'. Finance noted in its submission to the Senate Finance and Public Administration References Committee in February 1998 that:

> *Given that the cost of capital to the Commonwealth is around 12–14 per cent the hurdle rate of 15 per cent used in the financial analysis of the Government's domestic property holdings was arguably too low. The evidence suggests that hurdle rates in the private sector are commonly 15 per cent after tax and that some companies involved in property development use hurdle rates in excess of 25 per cent. At the*

> *time the decisions were taken on domestic property, the hurdle rate adopted by Commonwealth GBEs began at around 15–20 per cent. The Commonwealth Property Committee therefore erred on the side of caution using a hurdle rate of 15 per cent. The consequences of this decision would therefore have been that properties that would not meet a higher hurdle rate would have been retained. The Government would, however, be able to dispose of such properties at a later date.*[34]

2.10 While the CPPs reveal that Commonwealth property projects had been approved with a nominal 14 to 15 per cent rate of return, ANAO notes that three properties constructed around this time and reviewed in the audit had a lower rate of return. The rate required for the construction of Discovery House at Woden in the ACT was set at 10 per cent. The rental commitment and the rent review conditions for that property were based on that rate.[35] This building was purpose-built for the single Commonwealth tenant. ANAO was not able to identify the rate of return required on the RG Casey Building at the pre-construction stage. However, based on commencing rental and rent review procedures consistent with pre-construction commitments included in the 30 June 1997 market valuation, the Internal Rate of Return (IRR) was 9.8 per cent. Also, the capital use contribution required from AGSO for its Headquarters (before it moved to the long term sale/leaseback) was based on a return of 11.5 per cent on the value of the property (see Chapter 5).

2.11 The CPPs recognise that the practical effect of adopting a hurdle rate of 14 to 15 per cent was that it would be unusual for the Commonwealth to own property. The hurdle rate was based on advice from Finance that Commonwealth property projects had been approved with nominal rates of return of 14 to 15 per cent and that this rate would seem the appropriate figure for decisions about retention or divestment of existing property holdings. The report notes that the Government endorsed setting the hurdle rate at this level based on the following:

- an assumed risk-free rate of return of 6 per cent;
- a property risk premium of 6 per cent; and
- a further 3 per cent to reflect the additional risk incurred by the Commonwealth from the sub-optimal nature of the current Commonwealth property portfolio and the management risks associated with owning property.

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34 Submission to the Inquiry into the Sale of Commonwealth Property by the Senate Finance and Public Administration References Committee of February 1998.

35 The 10 per cent rate was set in 1993 at the time of pre-commitment for construction of the building, which was occupied from 1997.

2.12 A rate of return of 15 per cent for property is considered high by industry standards for a diverse property portfolio. The CPPs indicate that this figure was derived from rates of return approved by the then DOF for Commonwealth property projects. In October 1999, a consulting firm was commissioned by Finance to prepare an analysis of an economically-determined hurdle rate of return for property ownership by the Commonwealth.

2.13 The consulting firm reported to Finance in October 1999 using the Capital Asset Pricing Model (CAPM)[36] to generate an appropriate hurdle rate of return for public sector investment in property. It expected a return to commercial property to be above the risk-free rate but below the overall rate of return to equity. It considered the measure of property risk, or beta, to be between 0.4 and 0.6 of the expected rate of return on the market portfolio.[37] The report suggested that: '*the most likely estimate of the return to property is around 10 per cent, although there is considerable uncertainty surrounding this estimate*', based on the CAPM and using a range of values for the risk of property. It also stated that the firm was not aware of the origin and nature of any management risks specific to the Commonwealth that are in addition to the management risk incurred by the private sector and already reflected in the CAPM estimate of the return to property.[38] It noted, however, that the Commonwealth may have:

> *a particular risk aversion to owning property that is not reflected in the CAPM of the property beta or the Commonwealth may regard it as appropriate to add a further risk factor to allow for the inherent uncertainties involved in estimating the value of beta.*

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36 The CAPM uses a project specific cost of capital as the discount rate and is an important offshoot of the social opportunity cost of capital approach. The major features of the CAPM are the risk-free rate of return, an estimate of the risk premium that a well-diversified portfolio of assets is expected to achieve above the risk-free rate, and a measure of the risk of a specific asset compared to the risk of the portfolio. See Treasury Economic Paper No.14 '*Financial Monitoring of GBEs: An Economic Framework*.'

37 The beta of a company is a relative risk measure of a company's systematic, or undiversifiable, risk to the systematic risk of the market. In Australia, the All Ordinaries index is a common proxy for the market returns. The equity beta of the market as a whole is equal to 1 (asset beta will provide a lower number as the equity beta includes the effect of the gearing level of the firms). On average, a beta greater than 1 indicates the investment has a high systematic risk relative to the market, whereas, on average, an equity beta of less than 1 indicates the investment has a lower systematic risk relative to the market. See Australian Competition and Consumer Commission decision *Snowy Mountains Hydro-Electric Authority Transmission Network Revenue Cap 1999/00-2003/04* of 7 February 2001.

38 DOF noted in its November 1987 Discussion Paper, *The Choice of Discount Rate for Evaluating Public Sector Investment Projects,* that: '*other dimensions to risk arising from uncertainty in estimating the costs and benefits or concerns about possible biases that may be introduced by over-zealous proponents of a project should not be dealt with by adding an additional risk premium to the implied required rate of return, but by sensitivity analysis or more sophisticated Monte Carlo methods'* (p. 38).

2.14 In July 2000, Finance commissioned an external consultant to rewrite the CPPs, prepare a paper on the interpretation of the CPPs, and determine the Commonwealth's Social Opportunity Cost of Capital (SOCC). That external consultant engaged the same consulting firm that originally prepared a report to Finance in October 1999 on the hurdle rate of return for property. The report by the consulting firm, of October 2000, assessed the hurdle rate for application to property investment decisions applying CAPM.[39] The consulting firm concluded in its report that:

> *The empirical analysis outlined in this report suggests that the beta[40] of property investment can be estimated at approximately one half.[41] Using a risk free rate of 6.2% and an equity risk premium of 5.6% this suggests a central estimate of the market required return to property of approximately 9%. However, there is considerable uncertainty about the appropriate equity risk premium, even when estimated over long time periods. This suggests a wide range for the property hurdle return is appropriate, with the upper bound at approximately 11%.*

2.15 Another consulting firm provided a report to Finance in December 2000 and considered that it was:

> *appropriate to assess the SOCC on the basis of the weighted return activity of the total market, plus a conceptual risk allowance factor of 2–3% representing the Commonwealth's unique property risk…. Using the previously assessed risk free rate of 6.2%, plus a risk premium beta of 1.00 on the total market return of say 6% under current economic conditions, plus the conceptual property risk allowance of 2–3%, the current SOCC of 14–15% is supportable. On this basis, a SOCC of 14–15% appears to remain appropriate.*

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[39] The 1987 DOF Discussion Paper also supported the CAPM model as providing: '*a coherent framework for determining discount rates for the public and private sector alike. That is, in principle, the adjustment for risk of a public sector project should be the same adjustment as if that project was undertaken in the private sector. Only then will society's perception of risk be incorporated fully into all investment decisions'.* (p. 34).

[40] The consulting firm used three different data series to estimate the return to property. These were the Mercers Australian Unlisted Property Index (February 1987 to July 2000); the Rainmaker Direct Property Index (January 1985 to July 2000); and the Australian Stock Exchange Australian Listed Property Trusts Index (February 1987 to July 2000).

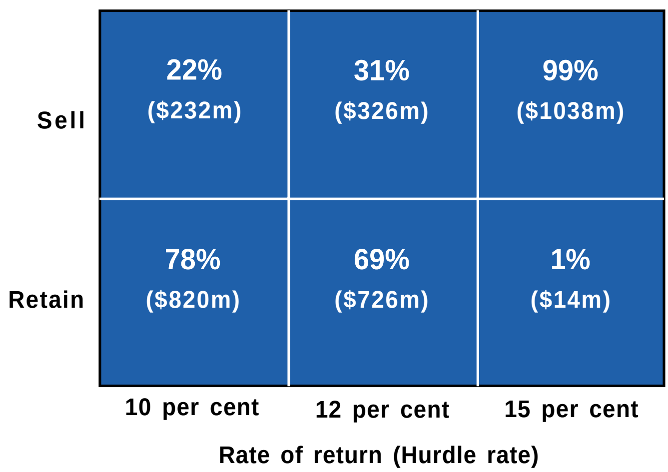
[41] The consulting firm reported: '*On the basis of the listed property trust regressions* [the consulting firm] *has adopted a central beta estimate of 0.46. Using the standard error of the regression estimates, the 95% confidence interval for the property beta estimate is 0.38 to 0.54. This interval will be used to put a range on the appropriate hurdle rate for property investments.'*

2.16 Finance is considering the December 2000 consultant's report, in regard to the appropriate hurdle rate of return in the CPPs. ANAO considers that the application of the average equity beta of the market (that is, 1) does not accord with the specific risks attributable to property. The risk measurement approach adopted by the consulting firm that reported to Finance in October 1999 and October 2000 (see paragraphs 2.13 and 2.14) using the CAPM model is consistent with project specific risk rates for property. This latter approach accords with that recommended by the then DOF in the 1991 *Handbook of Cost-Benefit Analysis* for the setting of discount rates. The DOF 1991 publication advocated that the best option in choosing a discount rate is to develop a project-specific rate using the CAPM framework.

2.17 ANAO's analysis indicates that, if a hurdle rate of 10 per cent (the rate considered appropriate by Finance's consultants in 1999) were applied, rather than the 15 per cent hurdle rate specified in the CPPs, only eight of the 59 properties would have been scheduled for divestment. These eight properties represented a book value of \$232 million or 22 per cent of the aggregated book value of \$1 052 million.[42] Figure 2.2 depicts the scale of divestment resulting from the application of hurdle rates of 10, 12 and 15 per cent.

Figure 2.2

Commonwealth divestment outcomes[1] at 10, 12 and 15 per cent hurdle rates of return



Note 1: Based on property book values as at 30 June 1996 used by the CPC.

Source: ANAO analysis of Finance records.

[42] The aggregated book value for properties included in the three year divestment program was \$1 052 million.

2.18 The use of an excessive hurdle rate of return will result in a sub-optimal investment outcome and financial loss to the Commonwealth when combined with leaseback arrangements. ANAO considers that Finance should review the methodology for deriving the hurdle rate to accord with commercial practice[43], and then review the ongoing application of the hurdle rate in the CPPs to reflect market movements in risk free rates and risk premiums. Accordingly, Finance should compare the risk-free rate (Commonwealth Treasury Bond rate) with the rate of return for the property and determine whether the premium over that rate warrants retaining that property in Commonwealth ownership. A hurdle rate of 15 per cent represents a 136 per cent premium over the monthly average Commonwealth Bond rate for the four year period ending June 2000.[44] A property with security of tenure to the Commonwealth in the form of a non-cancellable lease over a long period represents low risk and the criteria used for the hold / sell decision should reflect that risk profile.

2.19 Since 1997–98, the Department of the Treasury (Treasury) has undertaken a significant repurchase of Commonwealth debt. The pricing of the repurchase is based on the applicable yield curve for the Commonwealth. For the six month period ending December 2000, the average yield on 10 year Commonwealth Treasury Bonds was 6.02 per cent. Accordingly the opportunity cost of the Commonwealth investment of sale proceeds at effectively zero risk is the Treasury bond rate which, for a 10 year duration as of 29 June 2001, was 6.06 per cent.[45]

2.20 **Finding:** The CPPs refer to a hurdle rate of return of 14 to 15 per cent per annum. In applying the CPPs, the upper rate of 15 per cent was adopted. The practical effect of adopting such a rate, which exceeds normal commercial yields, for the decision to retain or divest property is that it would be unusual for the Commonwealth to continue to own property.

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43 The average yield on an investment in the listed property trust sector over the past 20 years was 8.7 per cent. Shares, Vol 6, No 4 April 2001, p. 20.

44 10 year Treasury Bond figures from the *Reserve Bank of Australia Bulletin January 2000* and *January 2001.*

45 ANAO noted in Audit Report No.14 1999–2000, *Commonwealth Debt Management*, p. 71, that:

> *in the 1998–99 Budget, the Treasurer announced that a range of financial management techniques (such as the purchase of financial assets to hold as Commonwealth investments) may be used to maintain the desired volume of Commonwealth Government Securities on issue, while at the same time reducing Commonwealth general government net debt. To enable the purchase of financial assets, the* Financial Management Legislation Amendment Act 1999 *permits the Treasurer to invest public money in any authorised investment for Commonwealth debt management purposes.*

2.21 In October 1999, Finance commissioned a consultant to determine the economic rate of return for Commonwealth property ownership. The consultant used the CAPM and reported that the most likely risk return rate should be around 10 per cent per annum, although there was considered to be uncertainty surrounding this estimate. The consultant provided a further report in October 2000 suggesting that, for CAPM purposes, the relative risk measure (beta) of property investment can be estimated at approximately one half (0.5) and suggested a central estimate of the market required return to property of approximately 9 per cent. The consultant noted there was considerable uncertainty about this estimate and suggested a wide range for the property hurdle return to be appropriate, with the upper bound at approximately 11 per cent.

2.22 Finance is now considering a further consultant's report of December 2000 in regard to the appropriate hurdle rate of return in the CPPs. ANAO considers that the application of the average equity beta of the market (that is, 1) proposed in that report does not accord with the specific risks attributable to property. The risk measurement approach adopted by the consulting firm that reported to Finance in October 1999 and October 2000 (using CAPM) is consistent with project specific risk rates for property. This latter approach accords with that recommended by the then DOF in the 1991 *Handbook of Cost-Benefit Analysis* for the setting of discount rates. That publication advocated that the best option in choosing a discount rate is to develop a project-specific rate using the CAPM framework. A property with security of tenure to the Commonwealth in the form of a non-cancellable lease over a long period represents a low risk and the criteria used for the hold/sell decision should reflect that risk profile.

2.23 The use of a hurdle rate of return that is too high would result in a sub-optimal investment outcome and financial loss to the Commonwealth when associated with leaseback arrangements. The aggregated book value for properties included in the three year divestment program was $1 052 million. ANAO's analysis indicates that if a hurdle rate of 10 per cent was applied (the rate considered appropriate by Finance's consultants in 1999), only eight of the 59 properties would have been scheduled for divestment, with a book value of $232 million; and applying a hurdle rate of 12 per cent would have resulted in divestment of only 23 properties, with a book value of $326 million. In contrast, actually applying a hurdle rate of 15 per cent would have resulted in divestment of virtually all of the property holding, or some 99 per cent ($1 038 million) by value of the property portfolio.

2.24 ANAO considers that Finance, in reviewing the market rate of return for property, should ensure that the methodology for deriving the required hurdle rate of return for existing property accords with the CAPM approach outlined in the Department of Finance's 1991 *Handbook of Cost-Benefit Analysis* by having a project specific risk rate for property.

Recommendation No.1

2.25 ANAO recommends that Finance, in its review of the methodology for deriving the hurdle rate of return in the Commonwealth Property Principles, have regard to including a project specific risk rate for property that accords with the Capital Asset Pricing Model approach outlined in the Department of Finance's 1991 *Handbook of Cost-Benefit Analysis*.

2.26 ***Department of Finance and Administration response:*** **Disagree.** Finance has reviewed the Commonwealth Property Principles (CPP) using a Capital Asset Pricing Model approach. The CPP hurdle rate is an investment benchmark, which also has regard to a number of other factors, including displacement effects and the opportunity cost of capital, and generic property considerations such as industry wide risk factors. Accordingly, in certain instances, Finance may recommend the use of a sector specific risk rate not a project specific rate.

2.27 **ANAO comment***:* ANAO considers that Finance should review the methodology for deriving the hurdle rate to accord with commercial practice. Finance's response to the recommendation notes that, in certain instances, Finance may recommend the use of a sector specific risk rate not a project specific rate. ANAO considers that the approach recommended by the then DOF in the 1991 *Handbook of Cost-Benefit Analysis* for the setting of discount rates is a more justifiable approach. The DOF publication advocated that the best option in choosing a discount rate is to develop a <u>project-specific</u> rate using the CAPM framework, which ANAO would support. A property with security of tenure to the Commonwealth in the form of a non-cancellable lease over a long period represents a relatively low risk and the criteria used for the hold/sell decision should reflect that risk profile. The risk measurement approach adopted by the consulting firm that reported to Finance in October 1999 and October 2000 (using CAPM) is consistent with <u>project specific</u> risk rates for property outlined in ANAO's recommendation.

Divestment strategy

2.28 In its November 1996 report, the CPC noted that the existence of legally binding commercially-oriented leases was fundamental to the success of a divestment strategy and the achievement of realisable values from sale. Accordingly, it recommended that agencies occupying space in Commonwealth buildings administered by the then DAS be required to commit to leases in a form proposed in the report. The CPC also reported that major issues remained unresolved in relation to properties located in the ACT.

2.29 A divestment strategy for Office Estate was put forward in the second report of the CPC issued in March 1997, which covered its review of 76 of the 140 properties in the DAS-administered Office Estate. The properties reviewed were those valued in excess of $1 million. These 76 properties had an aggregate book value of $1.3 billion, representing over 95 per cent by value of the estate. The CPC recommended the divestment of 57[46] properties which represented 81 per cent in value of the properties reviewed. It recommended that four properties located in the Parliamentary Triangle be retained on heritage and national estate grounds, and that there be further examination of the remaining 15 properties which posed particular problems due to vacancy factors, condition or location. Twelve of those properties were located in the ACT. Divestment was the CPC's preferred option for these 15 buildings.[47]

2.30 The divestment strategy recommended by the CPC was endorsed by the Government in April 1997. The Government was advised that the sale of the properties would increase net budget outlays in the longer term as future rental payments to the private sector grow. Finance progressed the three-year divestment program on the basis of the initial assessments made by the CPC and its economic advisers in 1997 of the rates of return calculated for each property subject to review. Finance advised ANAO that the CPC had responsibility for determining the application of the CPPs and had determined that this was the IRR from the perspective of an arms length investment property, and that the Government endorsed this approach.

46 This became 59 properties following the sub-division of a regional property and the inclusion of an additional property found to share plant with an adjacent building included for sale in the packages.

47 Finance advised ANAO that, as at March 2001, three of the ACT properties remained unsold. Two properties are empty and require complete refurbishment and a priority sale has recently been sought for the third property.

2.31 ANAO was not provided with documentation of actual recommendations to the CPC detailing the calculation of the rates of return used for divestment decisions. However, financial modelling was conducted on each building and reviewed by the joint external consultants engaged as advisers to the Committee. The initial financial modeling of the 76 office properties evaluated was undertaken by DAS. The CPC considered that the IRR measured the true rate of return over the entire period of the investment, including capital gain and rental growth, and the rate of return was used as the primary measure of property performance. The rate of return assessments prepared for the review of properties by the CPC were essentially from a vendor's perspective and, in effect, the evaluation process did not consider the 'opportunity cost' of leasing the property back after sale. Finance was unable to provide the analyses underpinning the final rates of return for each property reported by the CPC.

2.32 A strategy of individual and packaged sales was recommended by the CPC based on responses from industry and consideration of market factors. Divestment of the properties over a three-to-four year period was recommended over the immediate sale of all properties. It was recognised that the attractiveness of Commonwealth-owned properties to the private sector investment market is a function of the: location and geographic spread; scale and volume of portfolio; quality of stock; refurbishment requirements; capital growth opportunities; and yield. The strategy of packaging properties proved successful in achieving the divestment within assigned timeframes of all 14 high-value properties.

2.33 Grouping the high-value properties into packages was designed to offer the market geographically diverse properties; divest properties in the sensitive and poorly performing Canberra market by grouping them with sought-after property; and offer institutional purchasers a mix satisfying asset class investment and funds placement criteria. The CPC proposed that Domestic Property Group, of the then DAS, have contract management responsibility for the divestment program and that private sector consultants be engaged for implementation of the sale process, and for the provision of due diligence and legal services. The CPC intended that the sales adviser would refine the divestment strategy prior to commencing the sale process (see also Chapter 3).

2.34 Only seven of the 76 properties reviewed were assessed with a rate of return greater than the hurdle rate of 15 per cent. Despite exceeding the hurdle rate, six were recommended for divestment and one for retention due to its location in the Parliamentary Triangle. Finance advised that four of the properties above the hurdle rate were recommended for divestment as the CPC considered that some of the assumptions underlying the modelling in relation to rental growth projections and agency downsizing were overly optimistic and had the effect of unduly inflating the calculated rate of return figure.[48] Five of the six properties listed for disposal with hurdle rates exceeding 15 per cent have subsequently been sold.[49]

2.35 During the course of the CPC's review, the book values of the properties[50] were adjusted to take account of market conditions at the time and probable occupancy levels and leasing profiles.[51] The revised assessments prepared by the advisers to the CPC were not revised valuations for divestment, but represented potential sale proceeds. The adjustments reduced the value of the properties recommended for divestment by some $200 million, a one-fifth decrease in total value. However, rates of return for the properties were not re-calculated based on these revised assessments, which would have increased the rates of return, thus generally supporting a higher retention of properties in Commonwealth ownership.

2.36 The CPC proposed that each property be formally revalued at the time it was being prepared for sale, taking into account the commercially-oriented leases that would by then be agreed with agencies occupying the properties. ANAO identified one property included in Package 2 that had a hurdle rate greater than 17 per cent when it was sold. The rate of return was not routinely re-assessed at the point of sale of a property at which time the exact nature of what was being sold was known, contrary to the expectations of the CPC. Finance advised that the overall IRR for Package 2 was less than 15 per cent and that commercially it is not possible to offer a package of properties to the market and then withdraw one.

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48 Submission by the Department of Finance and Administration to the Senate Finance and Public Administration References Committee's Inquiry into the Sale of Commonwealth Property, February 1998.

49 Commonwealth Offices at Port Augusta and Port Lincoln in South Australia; 619 Murray St and ATSIC Regional Offices Perth in Western Australia; and 300 Queen St Melbourne in Victoria.

50 AVO advised ANAO that the instructions of the Australian Estate Management Division of the then DAS were to value the properties based on hypothetical 10-year leases with associated rents for book value purposes.

51 Individual property values were reduced by as much as 60 per cent through a combination of applying 'market sentiment' and 'perceived tenancy position' factors ranging up to 30 per cent and 40 per cent respectively.

2.37 The variation in valuations is outlined in Figure 2.3. The two major factors impacting on realisable value from sale were the tenancy profile of the property and the condition of the market in which the property was situated.

Figure 2.3

Movements in valuations of Commercial Office Estate properties approved for divestment in April 1997

Valuation	*Packages 1 to 6 ($ million)*	*All 59 properties ($ million)*
Book Value (June 1996)	853	1 052
Joint Advisers' adjusted value (Budgeted realisation—March 1997)	716	853
Market value before sale	787	953
Actual and expected proceeds	845	990[1]

Note 1: This figure comprises gross sale proceeds to April 2001 of $983 million, and anticipated proceeds from the three properties remaining unsold at April 2001.

Source: ANAO analysis of Finance records.

2.38 Finance advised ANAO that:

the book values as at 30 June 1996 were based on valuations that had been prepared for book purposes. In the vast majority of cases the valuations were based on hypothetical ten year leases and associated rents. The 30 June 1996 book values were profoundly affected by rent reductions and shortened lease terms negotiated by agencies during the Commonwealth Tenants' Lease (CTL) process in late 1996 and early 1997. Additionally the 1996 valuations did not reflect the large vacancies in Government owned buildings. Therefore the book values at 30 June 1996 are largely one of historical relevance. DOFA also note that often the due diligence on a property close to sale realised information that impacted on market value. This is why market value was rechecked and often found to be less than the book value from the previous year.

2.39 The CPC addressed the SP&I Estate in its third report. It reviewed all 141 SP&I Estate properties, which had an indicative market value of $381 million as at 30 June 1997, and recommended that 68 be retained. The 73 recommended for divestment had an aggregate value of some $120 million.[52]

2.40 The period over which the properties would be sold was not detailed. The AGSO property was included as a property recommended for retention and transfer to the user agency on the basis that the capital invested in the laboratory complex might not be realised if the property was sold and leased back to the Commonwealth. It was listed with an indicative market value of $80 million. However, sale of the AGSO property was subsequently approved by Ministers and included in the 1998–99 Budget, realising $152.4 million when divested in June 2000.

2.41 The CPC proposed a more commercial management regime for those buildings to be retained in the SP&I Estate. At the time, occupying agencies paid a capital use charge but were responsible for repairs, maintenance and refurbishment. The CPC proposed that the properties be centrally managed by Finance; agencies be charged a commercial rent; and repairs, maintenance and refurbishment be funded from the rental income. This was the system recommended by the CPC and adopted by Government for office buildings. However, the proforma lease subsequently developed by Finance for the SP&I Estate had agencies responsible for both market rent and repair and maintenance expenses. Finance advised ANAO that the market rent established is based on a net rent not a gross rent and that a net lease is a commercially accepted standard for SP&I buildings.

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[52] Of these:

- 19 were proposed for sale in the short term with vacant possession;
- 20 were proposed for sale/leaseback in the short term;
- 8 were identified as 'problem' properties with issues to be resolved prior to divestment;
- 15 were proposed to be transferred to the Department of Defence as they were indivisible from Defence establishments; and
- 11 were to be offered for sale to the Department of Defence because they adjoined Defence land and this would make them difficult to market.

2.42 **Finding:** The properties recommended for divestment by the CPC included six properties that were assessed at the time with rates of return exceeding the hurdle rate. In practice, although a hurdle rate of return was set in the CPPs, all properties that exceeded the hurdle rate were recommended for divestment, except one property in the Parliamentary Triangle retained in the public interest. The documentation made available to ANAO did not allow effective review of the assumptions underpinning the rates of return identified by the CPC for those properties recommended for divestment.

2.43 During the course of the CPC's review, the book values of the properties were adjusted to take account of market conditions at the time and probable occupancy levels and leasing profiles. The revised assessments prepared by the advisers to the CPC were not revised valuations for divestment, but represented potential sale proceeds. The adjustments reduced the value of the properties recommended for divestment by some $200 million, a one-fifth decrease in total value. However, rates of return for the properties were not re-calculated based on these revised assessments, which would have increased the rates of return, thus generally supporting a higher retention of properties in Commonwealth ownership. The CPC proposed that each property be formally revalued at the time it was being prepared for sale, taking into account the commercially-oriented leases that would by then be agreed with agencies occupying the properties. The rate of return was not routinely assessed at the conclusion of the tender evaluation and communicated to the decision-maker to inform whether the Commonwealth should retain or sell the relevant property.

3. Sale Management

This chapter discusses property sale costs and outcomes and the engagement of external advisers by Finance.

Background

3.1 In implementing the three-year divestment program, Finance relied heavily on the private sector to manage the sales process.[53] This included the use of consultants for property sales advice, legal advice, property marketing, and sales preparation including property due diligence. The divestment process was coordinated by the Divestment Unit within Finance. Finance advised ANAO that its role was to implement Government decisions for the divestment of property and that it was not charged with the role of protecting the overall interest of the Commonwealth.

3.2 For any large and complex asset sales program, the provision of a clear statement of objectives and adequate procedures and guidelines assists in managing the process and achieving good outcomes. ANAO was not able to identify a general statement as to the Government sale objectives set for the property divestment program. This contrasts with other major trade sales programs, such as the sale of the Federal Airports. Finance advised ANAO that the sales were consistent with the Federal Government's policy of releasing under-utilised capital tied up in property assets for re-allocation to higher priorities.

3.3 ANAO has previously reported that there were no public sector-wide, detailed guidelines which specifically address the conduct of the sale of Commonwealth properties.[54] ANAO has previously recommended that, in the absence of such guidelines, agencies charged with the disposal of substantial amounts of Commonwealth property would benefit from the development and application of appropriate guidelines and / or model processes.[55] The need for guidelines was also raised by Finance Internal Audit in its September 1997 report on the Review of Property Sales

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53 The use of private sector consultants in the management of the property sales process was recommended by the CPC.

54 Audit Report No.20 1996–97, *Selected Commonwealth Property Sales*, p. 5.

55 Audit Report No.20 1996–97, *Selected Commonwealth Property Sales,* Recommendation 8, p. 43.

Process, which examined the 1996–97 property disposal process. Finance did not have guidelines for the sale of Commonwealth property. Finance advised ANAO in April 2001 that divestment processes are covered by comprehensive formal legal advices, and documentation and procedures developed with legal and commercial advisers and Finance's Internal Audit area.

Divestment outcomes

3.4 The implementation of the three-year divestment program for the Office Estate commenced in 1997–98 and management of the process was focused on achieving the budgeted revenue target from sale of property in each financial year. Initially 57 properties were approved for sale, with 14 high-value properties grouped into six packages and 43 properties recommended for individual sale. An additional property was added to a package as it was found to have integrated building services and systems with an adjacent building included in the package. A further property, initially included as two properties, was subdivided during the sale preparation stage to three properties. The status of the 59 properties included in the three-year divestment program at the end of the period (30 June 2000) was 15 properties sold in packages, 37 properties sold individually and seven properties unsold.

3.5 Finance has measured the success of the sales program based on proceeds achieving the levels budgeted in each of the three financial years, and on sale proceeds realising or exceeding market valuations. Implied sub-objectives for individual and packaged property sales can be drawn from the Requests For Tender (RFTs) and tender evaluation criteria. In each case, Finance sought to determine best value to the Commonwealth through evaluation of the price offered, and risk of non-completion through adherence to foreign ownership and other tender conformance requirements. However, the individual tender evaluation criteria did not explicitly address how Finance would determine which offer represented the best value to the Commonwealth beyond being the highest price, as opposed to the option of retention if this provided a greater financial benefit to the Commonwealth. The sales process required purchasers to commit to Commonwealth leaseback arrangements providing guaranteed tenure to existing tenants of Commonwealth property sold in the divestment program.[56]

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56 In the RFT and sale contracts, a condition of sale was the agreement of the private sector purchaser to accept the leaseback arrangements not only to Commonwealth tenants but also to private sector tenants.

3.6 The gross proceeds from sale exceeded the sum of forecast revenue (see Figure 3.1) for each of the three financial years by a total of $95 million. Additional revenue from properties sold to April 2001 amounted to $35 million, taking total proceeds from sale to $983 million to April 2001. However, the total proceeds are some $69 million below the 30 June 1996 aggregated book value of $1 052 million.[57] The requirement to sell Packages 1 to 4 (Packages 1–4) in 1997–98 and Packages 5 and 6 (Packages 5&6) in 1998–99 was met, and in both years the gross proceeds from sale exceeded the market valuations for those packages. The budget projections for the packages were also equalled in 1997–98 and exceeded in 1998–99. The sale of individual properties generated less than forecast in the first two years, but is expected to exceed the three year budget forecast when the remaining properties are sold. Finance advised that sales of individual properties were smoothed across the program with the aim of achieving the sales targets, not exceeding them.[58]

Figure 3.1

Property sale proceeds 1997–98 to 1999–2000

	1997–98 $m	*1998–99 $m*	*1999–00 $m*	*Total $m*
Gross proceeds from packaged properties	483.2	360.9	-	844.1
Gross proceeds from individual sales	9.7	26.1	68.1	103.9
Actual Total Gross Proceeds	**492.9**	**387.0**	**68.1**	**948.0**[1]
Budgeted proceeds from packaged properties	484.2	230.1	-	714.3
Budgeted proceeds from individual sales	15.4	61.4	61.4	138.2
Budgeted Gross Proceeds	**499.6**	**291.5**	**61.4**	**852.5**
Increase (Decrease) actual sales proceeds over budgeted proceeds	(6.7)	95.5	6.7	95.5

Note 1: This figure does not include expected realisation from the seven properties unsold as at 30 June 2000.

Source: ANAO analysis of Finance records.

3.7 Prior to each sale, Finance obtained a market valuation of the property to establish a best estimate of the potential sale price. A valuation was also sought for each package of properties. Finance was successful in achieving sale prices in excess of market valuations for five of the six packages, and overall, sold at prices in excess of the total market

57 Finance advised that the final book value, at the time of sale, for properties sold was $908 million.

58 Finance advised that proceeds from property sales were returned to the Budget via equity repayments by Finance and that equity repayments were set as part of the annual Budget.

valuations for those packaged properties. Five of the six packages sold above market value, while five of the 15 properties included in the packaged property sales were concluded at notional sale prices below the current market valuation. During the sale process, Finance evaluated the purchase price for each package rather than the notional purchase price assigned by the purchaser to each property within the package. Of the 37 properties divested individually, 10 property sales (23 per cent) were concluded at sale prices below the current market valuation. Finance advised ANAO that:

> *once a decision was taken to package properties, only the total market valuation could be compared with the price received. All of the property packages except for Package 1 sold above market value. Package 1 sold at 5.6% below the market valuation. Given the cost of readvertising, remarketing, and capital holding costs, DOFA believe the decision to accept the reduced amount was reasonable. DOFA also notes that of the 10 individual properties that sold below market, one property, Rockhampton was sold as a concessional sale which was agreed by the Minister as per the Commonwealth Property Disposals Policy. Of the remaining 9 properties, the overall variation below market was less than 4.2%. Again DOFA believe that the decisions to accept the lesser amounts were reasonable given the costs associated with readvertising, remarketing and capital holding costs.*

3.8 **Finding:** Total gross proceeds from the sale of Office Estate properties included in the three year divestment program was $983 million as at April 2001, with three of the 59 properties remaining unsold. The sales program was successful in that total proceeds have exceeded revenue targets by $130 million or 15 per cent. However, the total proceeds are some $69 million below the 30 June 1996 aggregated book value of $1 052 million.

3.9 The requirement to sell Packages 1–4 in 1997–98 and Packages 5&6 in 1998–99 was met, and in both years the gross proceeds from sale exceeded the latest market valuations for those packages. One-quarter of the total properties recommended for divestment were packaged, and these realised 85 per cent of the total sale proceeds. The packaging strategy was successful in that it realised the sale of all properties in the required timeframes. Most material properties reviewed in the audit were sold at, or above, the final market valuation obtained at the time of sale.

3.10 The 1986 Commonwealth Property Disposals Policy provides that property having no alternative efficient use be sold on the open market at full market value. One of the six packages of properties and ten individual property sales (23 per cent) were concluded at sale prices below the current market valuation. Finance advised ANAO that the overall variation below market of nine of the individual properties was less than 4.2 per cent, and the other property was approved by the Minister for Finance and Administration as a concessional priority sale as per the Commonwealth Property Disposals Policy.

Cost of sales

3.11 Where properties were sold in packages, the direct costs of sales were maintained against the packages sold in each financial year. While some direct costs can be attributed to specific properties within those packages, a number of costs were attributed as services provided against all of the packaged properties within the financial year.[59]

3.12 Finance provided ANAO with an estimate of the costs attributable to the 59 properties, as a significant number of costs were not recorded to individual properties.[60] Costs captured with general applicability to the whole, or a significant portion, of the divestment program were apportioned pro-rata to individual properties on the basis of sale price. Total salary costs were estimated for 1997–98 and 1998–99, as the actual costs were not notified to the Divestment Unit, and apportioned to individual properties. Estimates were also prepared for the legal costs incurred in 1997–98, as these were not charged specifically to the divestment function within Finance. Legal costs were tracked by the Divestment Unit in Finance via a manual system but those records could not now be located. A number of transactions were unable to be identified by payee in 1997–98, amounting to 21 per cent of total cost of sales for that year. Accordingly, ANAO has not been able to fully audit the actual cost of sales figures provided by Finance.

3.13 Anomalies in the data were identified in reports from systems supporting the production of those figures. Finance advised ANAO that the shadow ledger has been reconciled to the general ledger from 1998–99 onwards. Delays were experienced in providing ANAO with Finance reports covering payments to specific contractors and access to archived payment vouchers.

59 For example, in many instances legal and marketing costs were not separately billed for each property.

60 Finance advised ANAO that: '*in a sales program of this magnitude, DOFA considers it unproductive, unreasonable and uncommercial to have tried to identify every cost to a property*.'

3.14 Based on Finance's estimates, the cost of sales for those properties included in the three-year divestment program was 2.1 per cent of sale proceeds, as outlined in Figure 3.2. The success fees for the sales adviser and sales agents' commissions accounted for nearly half the total costs. Legal fees represented about one-fifth of total costs. An industry benchmark for cost of sales of approximately 1.5 per cent (excluding due diligence costs) was identified by Finance in 1998. Finance advised that early experience showed that the Commonwealth's disposals would not be able to follow the usual divestment processes and would require significantly more work than private property sales. It further advised that no formal budgets were set for the sales of Packages 1 to 6 as cost estimates were extremely difficult to quantify. Finance advised ANAO that:

> *Commonwealth property is expensive to sell due to: environmental conditions, heritage characteristics, and no previous certificates of occupancy. DOFA notes that the CPC, after taking advice from industry, considered a figure of 3–4% would have been applicable for these properties. This was endorsed by Government through acceptance of the CPC reports. DOFA has used this range as guidance throughout the sales program. DOFA notes the 1.5% figure quoted by ANAO was used by DOFA in a tender evaluation report which specifically related to Packages 5&6. DOFA notes that the composition of Packages 5&6, major buildings in Melbourne and Sydney CBD and Canberra, had a different cost of sales profile to most properties sold during this program.*

Figure 3.2
Cost of Sales for the 56 Office Estate properties sold as at April 2001[61]

Expenditure type	*Cost $m*	*Per cent of total*
Sales adviser success fees	5.065	24.6
Legal advisers	4.488	21.8
Sales agent commission	4.152	20.1
Due Diligence/ Sales preparation	1.989	9.6
Marketing	1.421	6.9
Non-property specific costs[1]	2.069	10.0
Other	1.435	7.0
TOTAL COST OF SALES	**20.619**	**100.0**

Note 1: Includes Finance salary costs and general legal costs. Finance estimate that the salary and personnel costs for all property sales (including the 59 reviewed by ANAO) over the three-year period was $1.83 million.

Source: Divestment Unit of Finance

61 This does not include the cost of sale for the AGSO property in the SP&I Estate, estimated by Finance at $4.1 million and representing 2.7 per cent of sale proceeds.

3.15 Finding: The cost of sales were estimated by Finance at $20.6 million or 2.1 per cent of sale proceeds. The primary components of the cost of sales were payments to sale advisers, sale agents and legal advisers contracted from the private sector. The cost of sales was not maintained against individual properties in packages. Finance advised ANAO that the CPC, after taking advice from industry, considered a cost of sale figure of 3 to 4 per cent to be applicable for these properties, and that Finance has used this range as guidance throughout the sales program. An industry benchmark for cost of sales of approximately 1.5 per cent (excluding due diligence costs) was identified by Finance in 1998. Finance advised that early experience showed that the Commonwealth's disposals would not be able to follow the usual divestment processes and would require significantly more work than for private property. The Department further advised that no formal budgets were set for the sales of Packages 1 to 6 as cost estimates were extremely difficult to quantify.

Sales advisers

3.16 The sale of Packages 1–4 in 1997–98 was the first program of sales to involve outsourced project management. One firm was engaged as sales adviser from August 1997 to July 1999 for the sale of Packages 1–4 and Packages 5&6 and received $5.1 million in fees for these services (Packages 1–4 — $2.9 million, and Packages 5&6 — $2.17 million). A second firm was engaged in 1999 as sales adviser for the sale of the AGSO property and received over $2.5 million in fees for those services. The major services required of the sales advisers were to confirm the strategic approach, manage the preparation of due diligence, manage the marketing to maximise the exposure of the properties in appropriate markets, and to assist in the negotiation of the sales. The sales advisers were also members of the tender evaluation committee for properties sold by tender.

3.17 In each of these three major sale processes the sales advisers were paid a success fee on the proceeds from sale, which Finance advised is normal commercial practice within the property market. ANAO has previously recommended that success fee arrangements need to be well managed as they have the potential to encourage advisers to view maximising sale proceeds as the most important sale objective and evaluation criterion.[62] In situations where there may not be clear formal guidance from the Commonwealth on the relative importance of its sale objectives, such a view could result in less than satisfactory outcomes.[63]

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62 See paragraphs 3.2 and 3.5.

63 See Audit Report No.28 1998–99 *Sale of SA Rail, Tasrail and PaxRail,* p. 52.

Packaged property sales

3.18 In November 1996, the then DAS established two consultancy panels to manage the sale of Commonwealth properties.[64] The Advisory Panel consisted of six property specialists able to provide a wide range of pre-sales services, including up-to-date title documentation, surveys of net lettable space, engineering surveys, boundary surveys and documentation of heritage matters where required. The Sales Panel consisted of seven real estate agents able to manage actual property sales.

3.19 The sales adviser was initially selected from the Advisory Panel for its role in the sale of individual properties in 1996–97.[65] The firm was then contracted via a competitive tendering process from the Advisory Panel to manage the sale of Packages 1–4 in 1997–98. Nine proposals were received and four tenderers provided a presentation. Two evaluation reports were produced, one before the short-listing and a second after the presentations, which recommended that the proposal from that firm be accepted.[66] While the first report attempted to calculate the fees that could be charged by tenderers under their various proposals,[67] the final report did not make any conclusions on the relative merits of the fee structures proposed. The weighting for the cost criterion was 15 per cent with each shortlisted tenderer scoring equally, despite considerable variation in the fees proposed.[68]

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64 The panels were to operate for a period of two years, with an option for the Commonwealth to extend the arrangements for a further year.

65 The role of the firm in the initial 1996-97 sales was to co-ordinate and manage the overall due diligence process. It was not involved in the process after close of tender for the properties.

66 The Tender Evaluation Team recommended the appointment of the firm based on the significant amount of preparatory work it undertook to highlight understanding of the task; ability to demonstrate a broad range of experience spanning all facets of property financing, strategic property and portfolio analysis and high level real estate advisory capability; and the dedicated team proposed had the requisite skills and experience.

67 At the time of the evaluation the Tender Evaluation Team stated that even though all key selection criteria were addressed by this adviser, the costs would need to be examined more closely. It stated that the fee structure could limit the Commonwealth's options in achieving best value for money, based on the view that 0.6 per cent could be too high.

68 Capacity to provide the services was weighted at 40 per cent.

3.20 Exclusive of a sales agent component, the fee proposals submitted by the four shortlisted tenderers ranged nearly tenfold, from an estimate of $318 650 based on hourly rates, to a $3.1 million success fee. The success fee representing the most expensive option was accepted. The delegate was advised that the estimated fee was approximately $3 million, based on anticipated sales of $500 million at a fee rate of 0.6 per cent. While the successful firm proposed three different fee arrangements, the evaluation report did not state which of these was recommended for approval. The fee for sale agents was a component in the comparison of various fee proposals, however, an estimate of likely sale agent fees was not documented to allow an effective comparison of each firm's proposed fees. It was not apparent to ANAO how a delegate could make a decision to expend Commonwealth resources without making appropriate inquiries about the cost-effectiveness of the fee proposal. Finance advised ANAO that, '*in addition to the Tender Evaluation Report (TER) the (*approver*) received a presentation on the proposal, asked questions and sought additional information*.'

3.21 The appointment of the sales adviser was approved on 30 July 1997 and a contract was exchanged on 29 October 1997, three months into the 11 month term.[69] The contracted fee was the greater of a monthly retainer of $150 000 ($1.65 million) or an advisory fee of 0.6 per cent of the gross sale proceeds from Packages 1–4 (estimated at $3 million).[70]

3.22 In 1998–99, the same firm was appointed by sole sourcing for the sale of Packages 5&6 following its role in the sale of the first tranche of packaged properties. A non-competitive selection was adopted on the basis of earlier performance in this role in the sale process for Packages 1–4 and the need to complete the sales in the 1998–99 financial year. The timeframe was established in April 1997. Finance obtained legal advice that it was entitled to appoint within the Advisory Panel if that represented value for money and there were sufficient reasons for concluding that the Commonwealth would be unlikely to find equal value for money within the panel. Finance's Internal Auditor endorsed the appointment process on 4 June 1998.

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69 The contract commenced on 1 August 1997 and required the adviser to form an alliance with DPG with the objective of realising the maximum return for the Commonwealth while managing risks in the sales process to minimise the exposure of the Commonwealth to political, economic and administrative risks.

70 The fee paid to the firm for this role in 1997-98 was $2.9 million (0.6 per cent of $483.2 million).

3.23 The sales adviser was paid $2.2 million for project managing the sale of Packages 5&6. The report of the tender evaluation stated that the aggregate fee was likely to be over $1.2 million less than for Packages 1–4. ANAO notes that this could result from the sale of fewer buildings, with a lower overall value, and not as a result of a lower negotiated fee structure.

3.24 The proposal submitted by the firm included an efficiency dividend and a reduced monthly retainer to reflect the experience gained from its earlier involvement. Finance was concerned with the quantum of the efficiency dividend of $60 000 offered for the already established procedures[71] and requested the firm to reconsider the incentive-based fee arrangement.[72] Finance identified an opportunity for savings due to the lesser number of properties involved, the experience gained and processes established from the sale of Packages 1–4.

3.25 The successful firm was advised of its conditional appointment on 19 June 1998 and a contract was entered into on 17 August 1998 to project manage the sale process of Packages 5&6.[73] The efficiency dividend of $60 000 proposed by the firm was not included in the contract and there was no documentation provided by Finance to ANAO to support the exclusion of that condition from the contracted terms. The efficiency dividend was contingent on the re-engagement of the legal adviser firm and continuity of Finance staff in the sale process. Finance advised ANAO that key staff in Finance changed and the efficiency dividend was no longer available. The sales adviser advised ANAO in May 2001 that:

> *Between tender and contract documentation the core team was changed and therefore the dividend did not apply. Other savings within the proposal were based on the increased transfer of risk to [the sales adviser] from the Commonwealth due to a reduced retainer and increased reliance on the success fee for the total remuneration due. Whilst ultimately the same 0.6 per cent applied, the risk to [the sales adviser] was materially increased in the 5&6 sales programme—to the benefit of the Commonwealth.*

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71 Finance's letter to the firm of 18 May 1998 re request for Proposal—Sale of Office Property Packages 5&6 stated: '*DPG believes that, notwithstanding the existence of other timetable risks, that the benefits of established processes such as Certificate of Occupancy, Letters of Comfort, lease amendment actions and sub-contractors experience should serve to add greater value to the Efficiency Dividend.'*

72 In seeking clarification of the proposal, Finance advised the firm that it was unsatisfied with an efficiency dividend of $60 000. The firm responded that it was not prepared to increase the dividend.

73 The contract was for a term of 13 months commencing 1 June 1998.

3.26 The contracted fee was the greater of a monthly retainer of $120 000, or 0.6 per cent of gross sale proceeds, plus reimbursement of out-of-pocket expenses.[74] While the selection of the firm was justified on the basis of value for money, with reduced fees anticipated, in the event Finance did not benefit through a reduced fee as the success fee payable on sale proceeds exceeded the sum of the monthly retainers.

3.27 **Finding:** The evaluation report recommending acceptance of the proposal for the role of sales adviser for the sale of Packages 1–4 did not make any conclusions on the fee structures proposed, despite the nearly tenfold range in fees proposed by the short-listed parties from $318 650 based on hourly rates, to a $3.1 million success fee. The fee for sale agents was a component in the comparison of various fee proposals. However, an estimate of likely sale agent fees was not documented to allow an effective comparison of each firm's proposed fees, and it is was not apparent to ANAO how the delegate could make a fully informed decision to expend Commonwealth resources without making appropriate inquiries about the cost-effectiveness of the fee proposal.

3.28 For Packages 5&6, a non-competitive selection for the role of sales adviser was adopted on the basis of earlier performance in this role in the sale process for Packages 1–4 and the need to complete the sales in the 1998–99 financial year. The fee reduction of $60 000 proposed by the firm was not included in the contract. There is no documentation to support the exclusion of that condition from the contracted terms. The sales adviser advised ANAO in May 2001 that the efficiency dividend was based on the retention of the same sales team within Finance and that: '*between tender and contract documentation the core team was changed and therefore the dividend did not apply.*' The contracted fee was the greater of a monthly retainer of $120 000 or 0.6 per cent of gross sale proceeds, plus reimbursement of out-of-pocket expenses. While the selection of the firm was justified on the basis of value for money, with reduced fees anticipated, in the event Finance did not benefit through a reduced fee as the success fee payable on sale proceeds (which was the same as applied for Packages 1–4) exceeded the sum of the monthly retainers.

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74 A reduction from the $150 000 per month retainer under the previous contract.

AGSO sale

3.29 A firm was engaged by Finance on a sole source basis to act as the sales adviser for the AGSO property sale. The direct engagement of the firm was justified by Finance on the basis that the firm had already been engaged to negotiate the leasing arrangements for the SP&I Estate. The firm had been appointed by Finance in June 1999 to provide Transitional Property Portfolio Management Services, following a select tender where three parties were invited to tender. The proposal for the role of sales adviser, submitted by the firm on 20 September 1999, was accepted by Finance on 1 November 1999 but was not formalised in a contract until 15 February 2000. The contractual arrangements for the provision of services as sales adviser for the AGSO sale were incorporated into a general contract for consultancy services between the Commonwealth of Australia, represented by Finance, and the firm dated 15 February 2000.[75]

3.30 The firm's proposal referred to the valuation of the property undertaken by AVO as at 30 June 1999 of $90.54 million. The proposal was dated the same day that AGSO signed a Heads Of Agreement (HOA) document that put in place lease terms and conditions that had the effect of greatly increasing the market value of the property over that earlier valuation. The HOA, signed on 20 September 1999, provided agreement to a net lease[76], an annual rental amount in excess of market rent, a guaranteed annual increase in rent of at least 3 per cent, and a term of 20 years. In May 2001, the sales adviser advised ANAO that the increase in rental to $13 million and the term certain of 20 years should only have had an impact on value of approximately 10 per cent.

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75 The contract for the provision of consultancy services between that firm and Finance was signed on 25 February 2000 and covered services in relation to six projects including: provision of transitional property portfolio management services; facilitation of the sale process for the Deakin Offices ACT; acting as lead transaction adviser for the proposed sale of the AGSO Headquarters ACT; provision of development management services for the Adelaide Law Courts; review and management of key development projects; and review of key operational areas within the Development Management Branch.

76 The Real Estate Institute of Australia 1996, *A Glossary of Terms,* defines a net lease as a lease where, in addition to the rental stipulated, the lessee assumes payment of all property charges, such as taxes, insurance and maintenance. A gross lease is defined as a lease whereby the landlord pays for all repairs, taxes and operating expenses incurred through ownership. It is the opposite of a net lease in which these costs are borne by the lessee.

3.31 The Finance internal submission recommending acceptance of the firm's proposal, approved on 1 November 1999, also referred to a current valuation of $90.54 million for the property despite the lease terms having been agreed in September 1999. The significantly higher rents substantially enhanced the value of the property. In the submission recommending the firm to act as sales adviser, Finance noted that the fee proposed was in line with previous large sales but would exceed usual cost ranges if sale proceeds exceeded $110 million. Each of the four firms that submitted a tender in October 1999 for the role of sale agents to prepare and co-ordinate the marketing and promotion of the property had estimated the sale price to be in excess of $135 million. The Finance submission stated that achievement of prices in excess of this amount would represent an outstanding result and demonstrate the impetus given by linking the sale and lease negotiation.[77] Given the information available to both Finance and the sales adviser at the time, it was highly probable that the sale price would exceed $110 million given the lease terms that had been agreed on 20 September 1999. The range of fees that applied to the various sale outcomes is outlined in Figure 3.3.

Figure 3.3

Fee structure for sales adviser for AGSO property sale

Scenario	*Sales adviser fee*	*Per cent of sale amount*[1]
If sale achieved the Pre-lease valuation of $90.54 million[2]	$724 320	0.80
If sale achieved $110 million (value above which Finance considered usual cost ranges would be exceeded)	$1 000 000	0.91
If sale achieved the Market Valuation of $135 million (reflecting actual lease terms and conditions)[3]	$1 850 000	1.37
Actual Sale Price achieved of $152.38 million	$2 545 200	1.67

Notes

1: The success fee proposed by the firm and agreed by Finance was as follows:

- 0.8 per cent of sale price up to $100 million; plus
- 2 per cent of the amount greater than $100 million and less than $110 million; plus
- 3 per cent of the amount greater than $110 million and less than $125 million; plus
- 4 per cent for amounts greater than $125 million.

2: Valuation as at 30 June 1999 signed 5 July 1999.

3: Valuation for sale signed on 1 February 2000.

Source: ANAO analysis of Finance records.

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[77] In May 2001, the sales adviser advised ANAO that: '*the level of rental proposed to AGSO ($13 000 000) was not influenced by the fact that the property was being sold but was determined by an external valuation based formula that was developed at the commencement of the commercialisation process (July 1999) and that was applied to the entire SP&I portfolio as well as the Overseas Estate*.'

3.32 The tender evaluation report for the sale of the AGSO property noted that: '*an internal assessment of value undertaken by* [the sales adviser] *indicated a range of values from $145 million to $150 million*.'

3.33 ANAO has previously recommended that success fees should only be considered where an agency judges that it will improve value for money in sale outcomes.[78] ANAO has also previously recommended that success fees should be structured so that they are only payable where sale proceeds exceed independent third party benchmark valuations.[79]

3.34 **Finding:** A firm was engaged by Finance in November 1999 on a sole source basis to act as the sales adviser in the sale of the AGSO property, with success fees to be based on a sliding scale. Finance agreed to pay the sales adviser a success fee of 0.8 per cent based on a book valuation for the property of $90.54 million. Prior to approving this basis for payment, the value of the property was substantially increased by lease terms and conditions put in place for sale of the property. The property was subsequently valued at $135 million and assessed by the sales adviser with a range of values from $145 million to $150 million before sale. It sold for $152.4 million in mid-2000. The firm was paid a fee representing 1.67 per cent of sale proceeds, well above both the success fee of 0.8 per cent based on the $90.54 million valuation and the 0.6 per cent fee negotiated with the sales adviser for the packaged properties. Had the success fee been based on the June 1999 pre-lease valuation rate of 0.8 per cent of proceeds, it would have been $1.3 million less than the actual fee paid to the sales adviser for the AGSO sale.

Recommendation No.2

3.35 ANAO recommends that Finance review, in future property sales, the:

(a) payment of success fees to advisers on current market valuations for assets; and

(b) allocation of responsibility to external advisers for lease negotiations and sale management where success fees are calculated on the total proceeds from sale.

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78 Audit Report No.25 1998–99 *DAS Business Unit Sales—DASFLEET Sale*, p. 29.

79 Audit Report No.10 1998–99 *Sale of One–third of Telstra*, pp. 19, 39.

3.36 ***Department of Finance and Administration response:***

- **Part (a): Disagree.** No review is needed. Finance does assess success fees against market valuations of assets.
- **Part (b): Disagree.** No review is needed. Finance allocates responsibilities to external advisers in order to maximise returns to the Commonwealth from sale, while remaining within acceptable parameters and tenant requirements in terms of lease back arrangements.

3.37 **ANAO comment**: The AGSO property was valued as at 30 June 1999 at $90.54 million, based on a 15 year lease and an annual rental of $12 million. On 20 September 1999, a Heads of Agreement lease was entered into that provided agreement to a net lease, an annual rental amount in excess of market rent, a guaranteed annual increase in rent of at least 3 per cent, and a 20 year term which was negotiated by the sales adviser appointed by Finance. Each of the four firms that submitted a tender in October 1999 for the role of sale agents to prepare and co-ordinate the marketing and promotion of the property estimated the sale price to be in excess of $135 million. A firm was engaged by Finance on a sole source basis to act as the sales adviser for the AGSO property sale (after that firm had negotiated the new lease terms executed on 20 September 1999). The proposal for the role of sales adviser, submitted by the firm on 20 September 1999, was accepted by Finance on 1 November 1999 and formalised in a contract on 15 February 2000. The success fee proposed by the sales adviser and agreed by Finance was as follows: 0.8 per cent of sale price up to $100 million; plus 2 per cent of the amount greater than $100 million and less than $110 million; plus 3 per cent of the amount greater than $110 million and less than $125 million; plus 4 per cent for amounts greater than $125 million. In light of the significant difference in valuations over time for the AGSO property, and the factors that have contributed to this situation, the ANAO sees considerable merit in Finance reviewing its experience to assess whether the approach adopted in this case might be improved for the benefit of future sales.

Legal advisers

3.38 The major legal adviser was paid a total of $7.9 million for legal services provided to Finance relating to property divestments over the three years ending 1999–2000.[80] This included $1.5 million in 1997–98, $2.8 million in 1998–99 and $3.6 million in 1999–2000.[81] Finance advised that the total cost of legal services for the divestment of the 59 properties included in the three-year divestment program was $4.6 million, comprising $1.8 million for Packages 1–4, $1.5 million for Packages 5&6 and $1.4 million for properties sold individually.

3.39 In 1996, the legal adviser was appointed via a tender process as one of three members on the then DAS legal services panel, and, in 1999, the legal adviser was appointed, via a tender process, as one of four firms on the Finance legal panel. The 1996 Deed of Standing Offer (1996 Deed) was signed between the legal adviser and the Commonwealth, as represented by DAS, on 2 October 1996. The 1996 Deed provided the framework for engaging the legal adviser but required that an 'order' be placed by the Commonwealth to form the basis of a contract with the legal adviser for the provision of specific legal services described in the order. ANAO has not been able to identify any documentation that relates to the appointment of the legal adviser to provide legal services specifically for the property divestment process in 1996–97 or 1997–98.[82]

3.40 The legal adviser advised ANAO in June 2001 that its

> *appointment from within the DAS Legal Panel for the property divestments in 1996–97 and 1997–98 were each the result of a further competitive process within the Legal Panel—although further competitive quotation was not required in order for DAS to instruct a panel firm under the DAS Legal Panel Deed 1996–1999.*

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80 This amount has not been verified by ANAO. The figure provided by Finance for 1997-98 was estimated based on invoiced costs by the legal adviser. In 1997-98, legal fees were paid from a central fund and details were not reported back to the Divestment Unit. While it also tracked its legal costs via a manual system, those records could not be located at the time of the audit.

81 These amounts include the cost of legal services for all property divested in those three years, and not only the 59 properties included in the three-year divestment program reviewed by ANAO.

82 The DAS *Secretary's Accounting and Administrative Directions Part Two Section 13 Legal Services* dated 13 September 1996 states that officers wishing to access external legal services must fill in a Request for Legal Services form to be approved by a General Manager. Under those Directions the General Managers were primarily responsible for the management of legal services within their Sub-Program or Business Unit and Directors were responsible for the administration and monitoring of the provision of external legal services to the Department.

3.41 The 1996 Deed provided for fees in accordance with the tender response by the legal adviser unless DAS requested, and the legal adviser accepted, a different fee. At the time of audit, the tender response could not be located, and there was no documentation provided to ANAO by Finance to indicate that a fee different to that included in the tender response had been negotiated.

3.42 On the basis of its performance in Packages 1–4, the legal adviser was re-appointed on a sole source basis as the legal service provider for Packages 5&6. Finance considered that appointment of the legal adviser without a competitive tender represented value for money based on the experience gained from the sale of the first tranche of packages, the satisfaction with those services, and the timeframe for the sale of the final packages. Retention of the legal adviser was also favoured by the sales adviser to minimise the risks involved in the process and to provide continuity.[83] Appointment of the legal adviser was endorsed by Finance's Internal Auditor. In June 2001, the legal adviser advised ANAO that an additional competitive tender process was not required under the DAS Panel Deed.

3.43 On 4 June 1998, the appointment of the legal adviser was approved on the basis of best value for money and continuity. The recommendation proposed that a performance-based fee would be sought from the legal adviser, with fees discounted above a nominated fee cap. An estimate of the cost of legal services for the sale of the packages was not provided to the delegate. On selection, the legal adviser proposed an unconditional threshold of $900 000 above which a discount of 15 per cent would be applied for additional work to provide an incentive to act in a cost-efficient manner. This fee proposal was not taken up.

3.44 Finance advised ANAO that the total cost of legal services provided by the legal adviser for the sale of Packages 5&6 was $1.4 million, some 75 per cent higher than the estimate of $0.8 million quoted by the legal adviser after it was selected as the legal service provider. Finance advised that the fee proposal for legal services provided in the sale of Packages 5&6 was made during a major restructure of Property Group and a significant change in personnel concerned with divestment.

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83 The tender submitted by the firm for the role of sales adviser for Packages 5&6 included an efficiency dividend which was void if the previous legal firm was not retained as legal adviser for the property sales. The firm considered there to be significant risk exposure in bringing on a new legal adviser to the sale process.

3.45 In June 2001, the legal adviser advised ANAO that: '*the scope of the legal services specified at the time of the preparation of the estimate was significantly altered after the estimate was prepared, and that these changes in scope changed the resources required to undertake the task.*'

3.46 In October 2000, Finance advised ANAO that, in relation to the sale of Packages 1–4 in 1997–98 and Packages 5&6 in 1998–99: '*no estimate or fee budget was prepared as it was not possible to reasonably cost the nature of the task to be undertaken.*' ANAO considers that, based on the earlier packaged sales, an estimate of legal fees or a budget should have been developed by Finance for the legal services required under Packages 5&6. In commenting on the scope of the legal task carried out in the sale of Packages 1–4, the legal adviser advised Finance that the sales were a particularly complex and challenging task and that this was reflected in the amount of the legal services charged. However, the legal adviser was not requested to provide an estimate of the likely fees to be incurred in the sale of Packages 5&6 during the selection process.

3.47 Finance advised ANAO in April 2001 that:

> [The legal adviser] *were appointed for the sale of Packages 1–4 by a competitive process within the DAS panel. Fixed prices were not sought but the firms were encouraged to advise variations on their contract fee proposals in order to encourage value for money.* [The legal adviser] *proposed to use their most highly experienced solicitors from around Australia but based in Canberra.* [The legal adviser] *also proposed that there would be no charge for travel time or the cost of travel and accommodation. This arrangement has continued throughout the term of their appointments. Legal services were managed centrally by DAS and DOFA does not have access to any documents that supported this process and agreement.*
>
> *In May 1998 the then Manager of the Divestment Unit sought a proposal from* [the legal adviser] *for appointment for the 1998–99 year.* [The legal adviser] *offered a 15% cash discount above $900 000. At the time it was not considered that legal fees would exceed this amount to any great extent.* [The legal adviser] *did not offer to maintain the exemption for travel and accommodation costs as well as the 15% discount above $900 000. Due to a major change in the scope of works from what* [the legal adviser] *originally provided, the overall fees increased above $900 000.*[84] *It was agreed that rather*

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84 Finance advised ANAO that: '*the change in scope related to the inclusion of substantial construction work and new lease activities that had not been envisaged when the proposal was sought and were thus not included against the discount rate. This work would not have been included in the original discounting arrangement.*'

than a discount, the arrangement of not paying for travel and accommodation would continue instead. DOFA considers that the discount currently applied in relation to travel offers the best value for money to the Commonwealth. It enables DOFA to avail itself of the most qualified lawyers.[85]

3.48 ANAO review of payment vouchers for legal services provided in relation to property sales by Finance's legal adviser over the period 1997–98 to 1999–2000 revealed charging for both travel and accommodation costs and payment for these disbursements by Finance.

3.49 In June 2001, Finance clarified with ANAO the arrangement it had with the legal adviser with respect to travel on the divestment program:

The agreement to not charge travel time, travel or accommodation costs for key staff to be based in Canberra, did not cover other necessary travel in respect of a large Australia wide divestment program. The ANAO comments that travel costs were included in payments is consistent with this arrangement. Finance paid for the travel of non-key staff to Canberra and travel outside of Canberra.[86]

3.50 The legal adviser advised ANAO in June 2001 that: '*this agreement, which modifies the normal Panel fee arrangement for charging all time spent on Finance matters plus all disbursements, has provided DOFA with a substantial financial benefit.*' In respect of the property sales program in 1998–99, the legal adviser advised that it proposed, and Finance agreed, that, instead of a discount in the form of a discounted rate above $900 000 in fees, the existing discounting arrangement through travel costs and accommodation would continue.

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85 Finance also advised ANAO in April 2001 that the 5 per cent discount offered by the firm in its 1999 proposal '*is foregone for the ongoing agreement with* [the legal adviser] *to forego costs of travel, travel time to Canberra and accommodation within Canberra*.'

86 In June 2001, the legal adviser advised ANAO that the details of the travel and accommodation arrangements offered for the 1996-97 program of property divestments, in addition to providing local teams in each jurisdiction, were to:

- meet the cost of the core project management team meeting to provide advice and representation in Canberra on a weekly basis;
- not charge professional fees for travel time for all required travel on the project throughout Australia; and
- incur the cost of airfares to and accommodation in Canberra for the core team's participation in Canberra on a weekly basis in the management and direction of the program.

3.51 This firm also provided legal services for the sale of the AGSO property in 1999–2000. In the Finance Legal Services Panel RFT, the definition of services to be provided was very broad. The 1999 Deed of Standing Order (1999 Deed) indicates that the fees for services are as stated in the tender response by the legal adviser unless a different fee is requested by Finance and accepted by the legal adviser. The tender response provides for a volume discount of 5 per cent for allocated work exceeding $1 million per year where hourly rates as per the pricing schedule are charged. The response also provides for alternative pricing structures to be proposed by Finance, including fixed fee, performance-linked fee, capping arrangements and retainer. However, no documentation was identified that varied the legal adviser's fee structure for property divestment services from the pricing schedule included in the 1999 proposal. Finance's Internal Auditor advised that certain billings are excluded from this discount arrangement, including property sales work. No documentation was provided to ANAO to support the position that a volume discount was not applicable to legal services provided for property sales in 1999–2000, which Finance advised amounted to $3.6 million. Finance noted that it ran a competitive process for the legal services panel and that sales is a major element of its legal requirements. In June 2001, the legal adviser advised ANAO that: '*on the basis that work undertaken in relation to the property sales in 1999–2000 is subject to a special pricing structure (special travel and accommodation arrangement and no charge for travel time), this work is clearly excluded from the volume discount*.'

3.52 **Finding:** Finance estimated the cost of legal services provided by the legal adviser for the sale of packaged properties to be $3.6 million. The legal adviser advised ANAO in June 2001 that: '[its] *appointment from within the DAS Legal Panel for the property divestments in 1996–97 and 1997–98 were each the result of a further competitive process within the Legal Panel—although further competitive quotation was not required in order for DAS to instruct a panel firm under the DAS Legal Panel Deed 1996–1999.*' The legal adviser offered a fee discount for fees over a threshold of $900 000 for Packages 5&6 to reflect the experience gained in the earlier sales and the engagement for services was approved on that basis. However, a discounting arrangement was not reflected in any contractual documents.

3.53 Finance advised ANAO that the overall fees for Packages 5&6 increased above $900 000 due to a major change in the scope of works and that it was agreed that, rather than a discount, an arrangement relating to the charging of travel and accommodation expenses previously negotiated would continue instead.

Recommendation No.3

3.54 ANAO recommends that Finance review all material contractual arrangements with external advisers engaged in the property divestment process to ensure Commonwealth contractual commitments are fully documented and effectively managed.

3.55 ***Department of Finance and Administration response:*** **Disagree.** No review is needed. Finance has reviewed the issues raised by the ANAO and notes that they relate to a minor contract variation. The detailed knowledge of the variation by the contract manager and the adviser meant that the contract was being effectively managed.

3.56 **ANAO comment:** Successful contract management requires articulation of all the financial terms of a contract for services. There was no documentation of the agreed financial arrangement between Finance and its legal adviser for services provided in respect of property sales (see paragraphs 3.47 to 3.51). It is sound administrative practice to ensure that a written contract with an external adviser accurately reflects the agreed financial terms of the arrangement under which the services are being provided. For example, it provides a sound basis for the delegate approving the payment to ensure the payment accords with the contractual terms.

4. Sales Process

This chapter discusses the sale approval process and issues arising in the sales process from case studies selected for review in the audit.

Background

4.1 Considerable effort was required by Finance during the due diligence phase of the sale process to prepare the properties for market and to make available to prospective purchasers sufficient information on which to base conforming bids. A range of property information reports were commissioned by Finance and made available through the RFT process to expedite the sales process, provide comfort to prospective purchasers that properties were fit for occupation, and identify what was required for those properties to satisfy building requirements. The property information reports made available during the tender process facilitated the timely sale of properties by Finance. Finance advised ANAO that the prime purposes of the property information reports were to provide disclosure protection to the Commonwealth and to facilitate a transparent tender process.

4.2 The Commonwealth did not guarantee the completeness and accuracy of information in the reports, however, the terms of sale provided for purchasers to claim compensation of up to 5 per cent of the purchase price if errors were identified prior to settlement. Finance advised ANAO that only one such claim has been made and this has been determined at an amount approximating 0.02 per cent of the sale price of a Sydney property.

4.3 Legal issues were complex for Commonwealth properties located in the ACT. Amendments to the National Lands Ordinance were required to cover the issue of Certificates of Occupancy for ACT buildings. Letters of Comfort were developed following the creation of building files using reports prepared for the Commonwealth. The letters confirmed to prospective purchasers that, provided certain areas of work were addressed, the properties complied with the ACT Building Code for the purpose of obtaining a Certificate of Occupancy and Use.

4.4 In order to properly assess the market value of a property, the seller should know what is being sold and review any options available to maximise the proceeds from sale while protecting the interests of the Commonwealth. To establish a best estimate of the potential sale price, prior to each sale Finance obtained a market valuation for properties valued in excess of $1 million, where six months had elapsed since the previous valuation, or where changed conditions could have affected the value.

4.5 Most material properties were sold at prices at or above the final market valuation obtained at the time of sale. This is identified by Finance as a measure of success for the sale process. Figure 4.1 illustrates the movement in valuations leading up to sale for the case study properties considered in this audit. The initial valuations at the time the properties were identified for sale preceded the introduction of commercially-oriented leases transferable on sale of those properties. Final market valuations reflected the lease terms and conditions to be included in the executed leases for the properties. In the case of the lower value properties reviewed, the market valuations progressively decreased prior to sale (also see Figures 4.2 and 4.3).

Figure 4.1

Valuations and sale proceeds for case study properties

Property	*Initial valuation[1] ($m)*	*Market valuation at 30 June before sale ($m)*	*Final Market valuation for sale[2] ($m)*	*Sale price ($m)*	*Date of sale*
AGSO Headquarters	100.75	90.50	135 (1 February 2000)	152.38	31 May 2000
Package 3 RG Casey Building Commonwealth Centre Adelaide	218.20 184.20 34.00	193.70 165.00 28.70	192 167 28.6 (19 January 1998)	217.00 197.00 20.00	24 April 1988
Package 6 Casselden Place Edmund Barton Building	194.80 119.80 75.00	150.00 94.00 56.00	173 118 55 (18 December 1998)	201.30 142.10 59.20	22 April 1999
Package 4 Discovery House	30.00	28.50	30.0 (19 January 1998)	30.55	27 April 1998
Bendigo Commonwealth Offices	3.95[3]	3.62	3.17 (31 October 1999)	3.19	19 January 2000
Wagga Wagga Commonwealth Offices	4.40	3.19	2.5 (18 December 1999)	2.50	3 March 2000
Rockhampton Commonwealth Offices	3.75	2.50	2.1 (8 December 1998)	2.00	28 May 1999

Notes:

1: Initial valuations were those available at the time Office Estate properties were identified for divestment by the CPC (30 June 1996) and the AGSO property was identified for sale by Finance (30 June 1998).

2: Initial and Market valuations at 30 June for packages are included as the sum of the valuations for the properties within the package. The Final market valuation for sale for a package is a valuation sought specifically of the package of properties put to market.

3: Bendigo 30 June 1996 valuation included a small property at 265 Littleton Terrace which was valued following sub-division at $245 000 and that was subsequently sold separately for $205 000.

Source: ANAO analysis based on Finance and DAS documentation and financial data

4.6 Finance usually requests valuers to provide draft property valuation reports prior to submitting a final market valuation. The Divestment Unit indicated that this is standard commercial practice, particularly for major assets, as it enables material assumptions in the valuation to be checked and any errors corrected.

4.7 The value of a property is influenced by a number of factors including its tenancy profile, lease commitments, and expected terminal value.[87] The quality of tenancy information available for the sale due diligence process was found to be variable in the case studies reviewed for sale by tender.

Sale method

4.8 The method of sale selected can influence both the price achieved for the property (or package of properties) and the costs of sale. In some cases, the choice of method of sale of property may be simple, such as a traditional public auction where prospective buyers are given a description of the property features to be auctioned along with bidding instructions before the auction. Although there are various sale options available including sale by private treaty; public auction; national or international tender; or sale by expression of interest and limited tender, little detail was identified in the case studies of the rationale for the method of sale chosen.

4.9 The breakdown of the method of sale for the 59 Office Estate properties included in the three-year divestment program involved: 20 sold by auction for $33 million; 15 sold by international tender for $844 million; seven sold by tender for $49 million; nine sold by private sale for $20 million; one sold by concessional priority sale for $2 million; and seven properties were unsold at 30 June 2000 which Finance expected to realise $42 million. Only 25 per cent of sales were by international tender, although these included the high value properties and accounted for 85 per cent of sale proceeds. Sale by auction accounted for 34 per cent of sales, but only 3 per cent of sale proceeds.

87 Commercial properties, being income producing investments, are generally valued on the basis of capitalising a projected net income stream after making adjustments for the following: actual tenancies at the time of the valuation; anticipated delays in securing tenancies for the currently vacant space; an assessment of the condition of the property; and an allowance for the state of the commercial investment and rental markets for the area in which the property is situated.

4.10 The sale of the RG Casey Building provided for leaseback of the property to the Commonwealth for 13.8 years. Prior to sale, the lease between the Commonwealth, represented by Finance, as lessor, and the Department of Foreign Affairs and Trade (DFAT) as lessee, included a commitment for DFAT to pay Finance $0.52 million annually in addition to rental and other charges under the lease.[88] This was in consideration of the provision of agreed capital works forming part of the building, and reflected amortisation of those costs over the 15 year term of the lease. On sale of the property, this clause remained in the executed lease providing the new owner an additional income stream from the property. This annual commitment was not included in the market valuation for the property and this income stream, previously a payment from one Commonwealth agency to another, was sold along with the property.

4.11 Similarly, the sale of the Bendigo Commonwealth Offices also included an additional lease commitment of $0.12 million per annum for amortisation of the cost of fitout of the premises. The value of that cash flow represented approximately 10 per cent of the market value of the property, which included that lease commitment. Finance advised ANAO that it is standard commercial practice when there is an amortisation component relating to the lease that it is sold with the building. In the case of the Commonwealth, ANAO is unaware of a general practice of agencies selling to the private sector a stream of transfer payments between Commonwealth agencies. ANAO consider that best value for money for the Commonwealth is achieved when the whole-of-life costs and benefits are assessed.

Low value property sales

4.12 ANAO examined three lower value property sales comprising one priority sale and two direct sales following the properties being passed in at auction. Following identification of the Rockhampton Commonwealth Centre as a property for divestment by the CPC, the

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88 In November 1997, DFAT advised Finance:

> [DFAT] *continue to have serious reservations about a number of the commercial aspects of the lease which were not able to be renegotiated. Those reservations are based on concern that the sale and lease transactions were insufficiently driven by commercial standards to ensure best value for money was achieved. In particular,* [DFAT] *see no justification for the perpetuation in the lease of the amortisation arrangement after ownership of the building has been transferred to a private sector owner.* [DFAT] *are also concerned that the price structure of the rent and car park licence components of the lease do not reflect current market values.*

property was divested by way of a priority sale. The rationale for obtaining a third valuation during the sale of the property was not recorded and that valuation was accepted without any documented rationale for rejecting the second AVO valuation. The Minister was not advised of the second AVO valuation in the briefing recommending sale to that purchaser (see Figure 4.2).

Figure 4.2

Rockhampton Commonwealth Centre—Priority sale

Background

The Rockhampton Commonwealth Centre is a five-storey building located on the fringe of the Central Business District (CBD). Built in 1986, it was one of the more recent commercial buildings in Rockhampton at the time it was marketed. It comprises a Net Lettable Area (NLA) of 5 304 square metres with 51 car spaces and was 37 per cent occupied by Government tenants at the time of sale.

In August 1998, the Minister for Employment, Education, Training and Youth Affairs approached the Minister for Finance and Administration detailing a request by a publicly funded educational institution to occupy the Rockhampton Commonwealth Centre. The property had been assessed by AVO with a market value of $2.5 million as at 30 June 1998.

On 23 November 1998, the Minister agreed to offer the property to the institution as a priority sale at the market value of $2.5 million, consistent with the Commonwealth Property Disposal Policy. An updated valuation was sought and AVO assessed the property had a market value of $2.32 million as at 4 December 1998. The decrease in the valuation was attributed to a poor market and the then 38 per cent occupancy rate.[89] Another valuer was engaged on 6 December, who noted that it was doubtful that a marketing campaign would attract much interest and that the building was unlikely to attract a sale unless offered at a major discount below replacement value. A valuation of $2.1 million was established as at 8 December 1998. On 10 December, the institution asked that a purchase price of $1.9 million be accepted and on 21 December 1998 the Minister approved the concessional sale[1] to it at $2 million.

Outcome

The property was offered to the institution on 22 December 1998 at a concessional price of $2 million with an up-front payment of $1.9 million and two annual payments of $50 000. The contract was signed on 21 April 1999 and settlement took place on 28 May 1999 with the initial payment of $1.9 million. Based on the gross rental, the payback period was some six years. Following audit inquiry, Finance advised ANAO that the first annual instalment due on 28 May 2000 was invoiced and received in January 2001.

Note 1: A concessional sale is a priority sale concluded at a purchase price below market value, and under the Commonwealth Property Disposals Policy requires the approval of the Minister for Finance and Administration.

Source: ANAO analysis of Finance documentation

89 Fifteen per cent of the property was leased for 10 years, 21 per cent for five years, 12 per cent for three years, and 62 per cent of the property was vacant.

4.13 The Wagga Wagga and Bendigo Commonwealth Offices were reviewed as case studies (see Figure 4.3) as properties sold by private treaty after not selling at auction. It was originally intended that the Commonwealth Offices at Wagga Wagga be sold by public tender. The exclusive sale agent initially selected for the Wagga Wagga property was appointed in March 1999 for a period of six months at a commission of 0.85 per cent of gross sale price, with a $22 000 marketing budget covering the sale of this and another regional Commonwealth property. The sales agent was chosen by select tender from the Sales Panel to sell both properties. The marketing submission and letter of acceptance detailed that the property would be sold by public tender, with the submission indicating this would ensure maximum access and competition from the identified primary and secondary target markets. It was subsequently decided to sell the property by way of public auction. Using Finance costing figures, the cost of sales for this property was 3.2 per cent of gross sale price based on direct costs and 3.8 per cent using total costs.

Figure 4.3

Wagga Wagga and Bendigo Commonwealth Offices sales—Auction and direct (private) sale

Wagga Wagga Commonwealth Offices

Background

The land comprising the Wagga Wagga Commonwealth Offices property was sub-divided into three lots; one lot was sold to the City Council as a priority sale; the second lot became a public road; and the third lot housed the Commonwealth Offices. The Offices comprised two connected commercial office buildings constructed by or on behalf of the Commonwealth, the first in 1980 (two-storey and recently refurbished) and the second in 1992 (three-storey). It comprises a NLA of 4 134 square metres with 48 car spaces and was 61 per cent occupied by Commonwealth tenants at the time of sale. The property was initially to be sold by tender, but was put up for auction after a change in sale agents.

There was considerable movement in the valuation of the property before sale. At 30 June 1998, the Commonwealth Offices lot was assessed with a book value of $2.45 million. Finance obtained a current market valuation of $3.15 million as at 30 June 1999 for sale purposes. On 5 November 1999, the sales adviser to Finance recommended that this market valuation of $3.15 million be adopted as the reserve price for auction as changes occurring since the date of the initial valuation were not considered to have had a material effect on value. The auction was held one week later on 12 November, and the property was passed in after bidding reached only $1.5 million. Finance records indicate that the property was then put on the market with an asking price of $3.2 million. On 8 December, Finance appointed a further firm to conduct a current market valuation of the property. On 14 December, the selling agent advised Finance that an offer of $2.5 million had been made, subject to some adjustments to the Contract for Sale. A current market valuation of $2.5 million was provided as at 18 December. The sale was approved and contracts were exchanged on 20 January 2000.[1]

Outcome

The Commonwealth Offices was ultimately sold by direct sale at the then most recent market value figure of $2.5 million after being passed in at auction. Based on the gross rental, the payback period was some six years.

Commonwealth Offices Bendigo

Background

The Bendigo property comprised three separate buildings. Finance initially planned to sell these together, however, valuations of the three properties as a group and separately indicated that it was preferable to sell the properties individually. The property reviewed as a case study was known as the Centrelink Offices at 231–235 Lyttleton Terrace for which Centrelink was the sole tenant. It was a modern, well maintained single storey office building, purpose-built in 1995 for occupancy by Centrelink, comprising a NLA of 2 257 square metres with 12 car spaces. It was sold with three years remaining on the lease, with options for two further terms of five years each. The reserve price for auction was set at the market valuation as at 30 June 1999 of $3.62 million, however, the property was passed in at auction. A revised valuation was requested by Finance on 14 October 1999 and provided as at 31 October, stating a market valuation of $3.17 million.[2] The gross rental was considered by the valuer to be substantially above fair market rent. Final bids were sought from interested parties attending the auction and one bid was received on 22 October for $3.19 million subject to inclusion of a clause that the lessee be liable for any GST imposed on any payment made by the lessor.

Outcome

On 3 November 1999, the property was sold by private sale for $3.19 million, which was slightly above the revised valuation. Based on the gross rental, the payback period was some five years.

Notes:

1: In respect of the Wagga Wagga Commonwealth Offices, Finance advised ANAO that: '*in respect of the valuation, the market valuation as provided at 30 June 1999 appeared to be aberrant. Following failure to sell at auction, a revised valuation was sought from the Valuer who had previously valued the building at 30 June 1998. The firm had recent experience in the Wagga Wagga market and had in the immediate past concluded or advised on two sales of State Government property in the town*.'

2: In respect of the Commonwealth Offices Bendigo, the valuation of $3.17 million comprised $2.85 million for the property and $0.318 million for the fitout amortisation commitment under the lease.

Source: ANAO analysis of Finance documentation

4.14 Working papers prepared for the CPC indicate that the rates of return for the Rockhampton, Bendigo and Wagga Wagga properties were 16.53 per cent, 6.39 per cent and 16 per cent respectively. The CPC's March 1997 report recommending sale of the properties stated the rates were 14.85 per cent, 9.72 per cent and 8.71 per cent respectively. The basis for changes in the stated rates of return could not be established by ANAO.

4.15 **Finding:** Each of the lower value property sales reviewed by ANAO at Rockhampton, Bendigo and Wagga Wagga sold for prices well below the valuations used in the initial decision to divest the properties.

High value property sales

4.16 High value properties were generally sold by international tender. The sales adviser for the packaged properties was responsible for identifying and recommending the most appropriate method of sale. The sales adviser considered that sale by international tender indicated to prospective tenants a genuine intention to sell. In contrast, the joint advisers engaged to provide the CPC with independent advice in the formulation of the divestment strategy recommended a combination of sale by expression of interest, private treaty and auction. This approach was supported by industry consulted at the time. ANAO was unable to identify any documentation justifying the selection of international tender as the preferred method of sale for the packaged properties, given each type of sale method has different costs involved and will be of importance in achieving a successful outcome for the Commonwealth. The sales adviser for the package sales advised ANAO in May 2001 that:

> *Expressions of Interest were specifically excluded as it would have meant an extended sales campaign, with increased costs and no certainty of Tender upon which to base a shortlisting. Clearly this was inappropriate for the size and quality of the properties and Packages on offer. Only binding tenders with enforceable conditions could legitimately be used by the Commonwealth in accepting or rejecting an offer.*

4.17 Material made available to prospective purchasers included comprehensive Property Information Reports and lease exhibits. The information was provided with the intention of allowing bidders to significantly reduce their own review and promote the lodgment of conforming bids.[90] The sales adviser for the packaged sales also considered that the single-stage tender approach would encourage conforming bids or bids capable of comparative assessment. Finance advised ANAO that the prime purpose of the Property Information Reports was to reduce disclosure risk to the Commonwealth and ensure that the Commonwealth had complied with both its statutory and common law requirements.

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[90] While the Commonwealth did not guarantee the completeness and accuracy of information in Property Information Reports, the Contracts for Sale provided that a successful bidder could claim up to 5 per cent of the purchase price by reason of any error, misdescription or misrepresentation in the property reports, if lodged not later than three days before completion.

4.18 Despite adoption of a number of strategies to attract conforming tenders, overall there was a high incidence of non-conforming bids. Many non-conforming bids were conditional on further due diligence or included a request from the bidder for a period of exclusivity in order to undertake due diligence. Only one of the 23 bids received for individual packages for Packages 1–4 was ranked by the Tender Evaluation Team as a conforming tender[91] and all the successful purchasers of Packages 1–4 submitted non-conforming bids. Five of the seven bids for individual packages for Packages 5&6 were non-conforming[92], however, the successful purchaser lodged a conforming bid for the purchase of both properties.

4.19 Good administrative practice involves determining the basis on which the winning tender will be selected before the tender documentation is issued and devising evaluation criteria which will provide a methodology for distinguishing between tenders on that basis. The basis for selection and the criteria should also be communicated to potential tenderers through the documentation so that they have an informed basis on which to decide whether to prepare a tender.

4.20 The criteria for evaluation were included in the RFT for properties sold by tender. The criteria for the AGSO property sale comprised:[93]

- the price;
- agreement to pay the deposit;
- agreement to pay in accordance with the requirement specified in the contract;
- agreement to settle on or before the date of completion determined in accordance with the contract;
- the degree of conformity with the Transaction Documents and non-conformance of the tender;
- the provision of evidence required by Section 21A of the *Foreign Acquisitions and Takeovers Act (1975)* and Section 26A (where applicable);

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91 Fourteen bids were materially non-conforming, 11 of which were letters of intent only and did not include a signed contract.

92 Three bids were materially non-conforming.

93 Essentially the same criteria were used for the packaged property sales (excluding the seventh criterion above). However, the packages included two additional criteria, namely: '*where the Tenderer is a trustee of a trust, whether the trust is an Institutional Trust*;' and '*where a person is designated as a purchaser in a non-conforming tender, the Commonwealth being satisfied that one person is to take all responsibility for the performance of the purchaser's obligations in all contracts.'*

- the nature of advice received from the Treasurer in relation to the proposed acquisition by the tenderer (if applicable);
- the obtaining or ability to obtain any necessary approvals including governmental approvals; and
- any ongoing risk or exposure of the Commonwealth including the risk that the Commonwealth's preferred terms of sales may not be realised.

4.21 In the major property sales, the criteria were not weighted in the RFTs, there was no scoring of criteria, and no quantified risk analyses of the bids. The Tender Evaluation Plans (TEPs) listed price as the criterion of primary importance and the remaining criteria of secondary importance.[94] Previous ANAO performance audits of asset sales have recommended that criteria be weighted. In the light of the Hughes and McMillan Cases, care needs to be taken to ensure that no representation is made to tenderers that the criteria will carry equal weight in the evaluation process if there is any possibility that the representation will not be fulfilled in the evaluation.

4.22 Sales were generally concluded with the highest bidder lodging a conforming bid, or the highest non-conforming bid that was considered commercially acceptable after the clarification process. Four of the six packages were sold to the highest bidder. The three highest bids for one of the packages were 'letters of intent' only with conditions that were significantly non-conforming with the RFT. The highest bidder in the other package was selected as the preferred tenderer but withdrew prior to approval of the sale by the delegate.

4.23 The RFTs for the sale of properties included in the divestment program generally included a clause that allows the Commonwealth to negotiate with any one or more tenderers.[95] In the AGSO property sale, four tenders were considered by the Tender Evaluation Committee (TEC) to be commercially acceptable to the Commonwealth. The tenderer with the highest bid in this group was approved as the preferred tenderer. A number of the tender evaluation criteria related to the ability of the tenderer to complete the sale. In particular, the criteria included

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94 While the TEP for Packages 1–4 could not be located by Finance for ANAO review, it was evident from the evaluation process that price was assessed as being of primary importance as specified in the TEP for Packages 5&6 and the AGSO property.

95 For example, Clause 5.3(e) of the AGSO property and Package 6 RFT Tender Conditions.

agreement to pay the deposit; agreement to pay in accordance with the requirements specified in the contract; agreement to settle on or before the date of completion determined in accordance with the contract; and assessment of any ongoing risk or exposure of the Commonwealth including the risk that the Commonwealth's preferred terms of sale may not be realised. The evaluation report did not address how the tenders were assessed against these criteria. Risk assessments were similarly not documented for the packaged property sales.

4.24 The purchaser of Package 3 (comprising the RG Casey Building and the Adelaide Commercial Centre) lodged two tenders. One was an unconditional offer of $205 million for the package and the second was conditional, where the price bid for the package ($221 million) could fall by up to $15 million if interest rates increased. Finance retained an open exposure to this risk and, as a result of interest rates increasing, the Commonwealth received $4 million less for the package than the nominal tender price of $221 million.[96]

4.25 ANAO has recommended that agencies identify, assess and manage interest rate risk to the Commonwealth during asset sales.[97] This was done by the Office of Asset Sales and IT Outsourcing (OASITO) in its March 1998 evaluation of tenders for the leasehold sale of the Phase 2 Federal Airports.[98] At that time, based on the interest rate futures and the term structure of these interest rates, OASITO's Business Adviser assessed that it was likely that rates would increase over the following months, reducing purchase prices offered by some bidders. The strategy adopted by OASITO was to seek the removal of interest rate conditions for the proposed preferred candidates before they were confirmed as preferred.

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96 Finance received legal advice on 27 February 1998 that the tender had not clearly identified the interest rate that is the reference point in calculating the purchase price. This was not subsequently clarified and Finance records did not include a comparison of the relevant reference rate between the time the tender was lodged and exchange of contracts.

97 See Audit Report No.38 1997-98, *Sale of Brisbane, Melbourne and Perth Airports*, p. 41.

98 See Audit Report No.48 1998-99, *Phase 2 of the Sales of the Federal Airports*, p. 56.

4.26 In comparison, Finance did not obtain advice as to whether the interest rate condition in the successful tender needed to be managed, or how this should be done. In the circumstances,[99] given the significance of the risk to maximising the sale price, better practice would have involved Finance assessing the risks and options for managing the interest rate exposure, for example considering an over-the-counter Forward Rate Agreement.[100] The sales adviser advised ANAO in May 2001 that:

> *The sale of a property via binding tenders is not comparable to other OASITO sales where extensive negotiations are entered into once a preferred tenderer is identified. In these property sales, once the recommended purchaser is approved, a contract is immediately entered into (thereby eliminating any variation in price or negotiation of terms). No time elapses between the point of being 'preferred' and the sale price being determined at the point of contract, therefore no pricing risk (under the meaning within the context of other OASITO sales) exists.*

4.27 In February 1998, a probity audit of the sale process was conducted on completion of the evaluation process before the Secretary was requested to approve the sale of Packages 1–4. Finance Internal Audit addressed this requirement in a file note dated 9 February 1998 in which a number of questions were identified for coverage and the required audit approach and opinion was detailed.[101] In a review of the sale process for Packages 1–4, greater involvement of Internal Audit throughout the tender and sale process was identified as an area for improvement for later sales, as opposed to review on completion of the evaluation process.

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99 Seeking the removal of this condition was not an option as the unconditional tender indicated that removing the interest rate condition (which was the only substantive difference between the two tenders) would reduce the price bid to $205 million whereas accepting the conditional tender would have realised at least $206 million.

100 A Forward Rate Agreement is an interest rate hedge which allows borrowers and lenders to lock into future interest rates without exchanging the principal amounts of the borrowing or loan. See also Audit Report No.45 1999-2000, *Commonwealth Foreign Exchange Risk Management Practices.*

101 This document was provided to ANAO in response to a request for the probity plan adopted for the sale process.

4.28 ANAO notes that the sale of Package 4 and the AGSO property were not concluded with the preferred tenderers identified in those reports. No additional probity reviews were conducted before the ultimate purchasers were approved for these sales, even though, in the case of the AGSO property sale, a supplementary tender evaluation report was prepared. Finance advised that:

> *for the sale of Package 4 and the AGSO property the tender evaluation report clearly identified the sequence of events that would follow should certain events happen ie tenderers withdraw. These reports had been reviewed by probity auditors and no further probity audit was necessary. The ultimate sale was completely consistent with the original tender approval.*

4.29 As an initial step in conducting a probity audit, the auditor would normally develop a probity plan. This represents good administrative practice. By articulating the probity principles to be considered and audit work to be undertaken, it enhances the ability to demonstrate the basis for assessments subsequently provided regarding the probity aspects of the tender process. A properly prepared probity plan represents a clearly articulated and objective model for the proper conduct of the tender process, against which its actual conduct may be assessed from a probity perspective. The probity plan guides the probity auditor as to the issues to be examined in determining whether there has been due and proper conduct.

4.30 Probity reviews were conducted for the sale of the packaged properties and the AGSO property, however, a probity plan was not identified under which those reviews were conducted. Finance advised ANAO that a Risk Management Plan was developed between the then DAS and the sales adviser for the sale of Packages 1–4 and that elements of that plan and the solutions reached were carried forward in all future sales.

4.31 **Finding:** The majority of bids lodged for the packages were categorised as non-conforming. Many non-conforming bids were conditional on further due diligence or included a request from the bidder for a period of exclusivity in order to undertake due diligence. Only one of the 23 bids received for individual packages for Packages 1–4 was ranked by the Tender Evaluation Team as a conforming tender and all the successful purchasers of Packages 1–4 submitted non-conforming bids. Five of the seven bids for individual packages for Packages 5&6 were non-conforming, however, the successful purchaser lodged a conforming bid for the purchase of both properties.

4.32 The criteria for evaluation were included in the RFT for properties sold by this method. In the major sales, the criteria were not weighted. There was no scoring of criteria and no quantified risk analyses of the bids. The criterion of primary importance was effectively price. Sales were generally concluded with the highest bidder lodging a conforming bid, or the highest non-conforming bid that was considered commercially acceptable after the clarification process.

4.33 The successful tender for Package 3 (RG Casey Building and Adelaide Commonwealth Centre) included a condition whereby the purchase price could fall by up to $15 million in the event that interest rates increased. Finance did not obtain advice as to whether the interest rate condition in the successful tender needed to be managed, or how this should be done. In the circumstances, given the significance of the risk to maximising the sale price, better practice would have involved Finance assessing the risks and options for managing the interest rate exposure, such as through a Forward Rate Agreement. Finance retained an open exposure to this risk and, as a result of interest rates increasing, the Commonwealth received $4 million less for the package than the nominal tender price of $221 million.

Recommendation No.4

4.34 ANAO recommends that, for property sale tenders, Finance:

(a) evaluate the merits of incorporating, as part of the tender evaluation process, appropriate priorities that set out the relative importance attaching to each evaluation criterion; and

(b) document explicit consideration of the extent to which tenders comply with all evaluation criteria identified in the Request For Tender.

4.35 ***Department of Finance and Administration response:***

- **Part (a): Disagree.** No evaluation is required. Finance notes that the criterion for assessing property sales was the highest price of a commercially acceptable proposal given the established lease and condition of the property.
- **Part (b): Disagree.** Finance is satisfied that the tender evaluation panels considered all evaluation criteria. Tender evaluation reports are independently reviewed by Finance Internal Audit to ensure Tenders have been assessed against the evaluation criteria in the Request for Tender.

4.36 **ANAO comment**: The RFTs for property sales by tender listed the evaluation criteria but did not assign priorities to the criterion. In the tender evaluation process, price was accorded primary importance. In the sale of the AGSO property, there were eight other criteria in addition to price (see paragraph 4.20). The evaluation report did not address how the tenders were assessed against these criteria, and risk assessments were similarly not documented for the packaged property sales. In the case of the AGSO sale, the preferred tenderer did not complete the sale as it withdrew after selection. The recommendation is directed at supporting the establishment of an appropriate framework for determining the basis on which the successful tenderer would be selected before the tender documentation is issued, and for devising the methodology for distinguishing between tenderers. It is acknowledged good administrative practice for the evaluators to decide how the criteria would be applied before they consider the tenders. In property sales, this would involve incorporating into the tender evaluation planning process consideration of the means by which each tenderer would be ranked in terms of the criteria.

Sale approval

4.37 The approver of a Commonwealth property sale effectively endorses both the sale of the property and the execution of leases for the property with the proposed purchaser. The *Financial Management and Accountability Act 1997* (FMA Act) provides for the making of regulations in relation to the disposal of public property. FMA Reg 7 provides for the Minister for Finance and Administration to issue guidelines for the procurement of property and services, including the disposal of public property. The decision to enter into a lease between the Commonwealth and a successful purchaser of a property also 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 Regulation 9 or 10. Under Regulation 9[102], a decision to spend public money cannot be made:

> *unless the relevant approver is satisfied, after making inquiries as are reasonable, that the proposed expenditure: (a) is in accordance with the policies of the Commonwealth; and (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.*

[102] AGS advised ANAO that:

> *in* [AGS's] *view, the meaning of 'and' between FMA Reg 9(1)(a) and 9(1)(b) indicates that the requirements set out in those paragraphs are cumulative. That is, there is a requirement to comply with all three paragraphs. The word 'and' when it appears in legislation and joins two requirement, usually indicates that the requirements are cumulative. This is not an invariable rule of statutory construction and the question will always be one of statutory construction (see* Secretary, Department of Employment, Education Training and Youth Affairs v Gray (1999) *91 FCR 254 per Hill J).*

4.38 AGS advised ANAO 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 Regulations. These policies would consist of the: Commonwealth Property Disposals Policy; Commonwealth Property Principles (CPPs); Commonwealth Procurement Guidelines (Guidelines); and, Chief Executive's Instructions (CEIs).

4.39 The inquiry of whether or not the Commonwealth should enter into a lease with a prospective purchaser (the terms and conditions of which form part of the RFT) should be made by the relevant Finance officer who has determined that the property is to be sold. An inquiry involving Regulations 9 or 13 may have already been made in the past by the Commonwealth lessee agency (in occupation of the property) before entering into the 'notional' lease with Finance (as lessor). In terms of the relevant inquiries to be made under Regulation 9 for sale and leaseback transactions, the Guidelines issued by the Minister specify that in the procurement of goods and services, Commonwealth policy requires agencies to seek value for money so that the most cost-effective outcome may be achieved. Such an inquiry process necessarily involves Commonwealth officers in making comparisons of costs and benefits of sale and leaseback. The Guidelines state that price alone is not often a valuable indicator of value for money and in respect of entering into financial commitments such as contracts, persons should be satisfied that the Commonwealth is unable to obtain better value for money. AGS advised ANAO that:

> *In our view, it would be a unique situation for there to be a Commonwealth direction for disposal of public assets regardless of the price. Under FMA Reg 7(2) Commonwealth Procurement Guidelines issued by the Finance Minister* ***must not be*** *inconsistent with the FMA Act, FMA Regs or FMA Orders (our emphasis). Consistent with the Commonwealth Procurement Guidelines, a decision to dispose of public property must secure the best financial outcome for the Commonwealth and be at full market value (as well as complying with any other relevant policies).*[103]

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[103] The Commonwealth Property Disposals Policy provides for priority sales to be concluded at a price below market value on the approval of the Minister for Finance and Administration.

4.40 The inquiries needed to assess that the entry of a lease represents value for money may include arriving at a view that leasing a property may not represent a 'value for money' outcome. That may involve an assessment of the best overall net outcome for the Commonwealth and should take into account the relevant whole-of-life costs and benefits as provided in the Guidelines. This involves identifying and comparing whole-of-life costs and benefits on a common basis over time, such as calculating Net Present Values (NPV). In those circumstances, a decision could include that a property to be sold (which is to be subject of a long-term lease) should be withdrawn from sale and that the Commonwealth retain ownership rather than leasing the relevant property.

4.41 In the property sale transactions reviewed by ANAO it was not apparent that a systematic process of inquiry, as required under the FMA Regulations and the Guidelines, was conducted by Finance prior to executing the sale contract and leasing arrangements with the purchasers. If a decision is made for example, that the lease does not represent value for money, as noted above a further decision could include that the property to be sold (which is to be the subject of the lease) should be withdrawn from sale and retained. Similarly, a decision might also be made that the terms and conditions of the lease be revisited and the property sale proceed subject to a lease with different terms and conditions. This may involve the Commonwealth (depending on the particular facts and circumstances) having to re-tender the property sale.

4.42 Finance advised ANAO in April 2001 that:

> *DOFA's role was to implement the Cabinet decisions to divest property in accordance with the Commonwealth Property Committee (CPC) reports. DOFA was not charged with the role of protecting the "overall" interest of the Commonwealth. The overall interests of the Commonwealth were considered in the development of the Commonwealth Property Principles (CPP) and the CPC's implementation. Each occupying Department was involved in negotiating leases and thus ensuring the operating and financial arrangement for their agency.*[104]

[104] ANAO Report No.53 2000–01, *Commonwealth Management of Leased Office Property*, concluded that: '*from this analysis it is evident that the case study agencies* [which included DFAT] *are managing Commonwealth sale/leaseback leases that contain provisions over which they had limited ability to negotiate. This can inhibit the agencies' ability to ensure that resources are used efficiently and effectively*' (p. 73).

4.43 Given the administrative division of responsibility and accountability, ANAO considers that Finance is the only agency in a position to ensure that property divestment is consistent with the CPPs, and to make an informed judgment as to whether a property sale and leaseback transaction represents efficient and effective use of Commonwealth resources and is in the overall interest of the Commonwealth. AGS advised ANAO that in undertaking a property sale and leaseback transaction it would be incumbent on Finance officers to consider and comply with FMA Reg 9. AGS advised ANAO that:

> *it would be difficult to contemplate a situation where adherence to FMA Reg 9 was not required in property sale and lease back transaction. Under FMA Reg 13 the entering into the lease involves the entering into a 'contract under which public money is, or may become payable' and is prohibited unless the proposed contract has been approved under Regs 9 or 10.*

Sale and leaseback better administrative practice

4.44 AGS advised ANAO that good administrative practice for an agency disposing of Commonwealth property with a long-term leaseback arrangement requires the following inquiries to be made by the approving officer:

(a) determining whether or not the property should be sold in accordance with the relevant policy;

(b) if a decision is made that the relevant property falls within the policy, establishing the full market value for the property;[105]

(c) the 'full market value' should reflect whether there are special conditions attaching to the property and the price should reflect the fact the property is sold with a secure Commonwealth leaseback arrangement;

(d) the decision to sell the property with a leaseback to the Commonwealth should also involve a separate inquiry to that involved in (c) above. That is, an application of FMA Regs 9 and 13 together with those inquiries under the *Commonwealth Procurement Guidelines*. This is on the basis that the decision to enter into a lease with the successful purchaser of a property involves the entering into a contract for the purposes of FMA Regs 9 or 10; and

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[105] Where the property contemplated for sale is in a unique area where there is no competitive market, or is a specialised facility, and where it is offered to the market with a long-term leaseback arrangement to the Commonwealth, it would be good practice to obtain more than one independent valuation to ascertain the appropriate price for the property.

(e) the inquiry noted in (d) above should be undertaken by the relevant Commonwealth officer responsible for the sale of the property irrespective of whether or not a similar inquiry had been undertaken by the Commonwealth agency in occupation of the property under the initial notional lease.

4.45 Finance's CEIs issued in January 2001 addressed the disposal of public property and went some way towards reflecting the improved administrative practice for the property sale approval process outlined above. The Instructions provided at 5.3.1 that:

> *In considering any proposal, the General Manager must:*
>
> *a) be satisfied that any planned disposal is able to withstand public scrutiny in terms of value for money, probity and ethical grounds; and*
>
> *b) ensure that all disposals of public property secures the best financial outcomes for the Department.*
>
> *Where the disposal is of a major or strategic asset, the approval of the Secretary shall be required. The briefing required shall include a full evaluation, risk assessment and consideration of all major policy implications, with input from other relevant policy agencies.*[106]

4.46 Finance advised ANAO in June 2001 that, in respect of the Finance CEIs of 12 January 2001, as amended to 12 May 2001:

> *Instruction 5.3 has been amended to remove real property disposals from its operation. The clause's main purpose, as evidence from its wording, was to deal with disposal issues related to excess or surplus stationary, equipment and office machinery etc. A new draft CEI dealing with the disposal of real property assets is being developed.*

[106] The Instruction further provided at 5.3.2 that: '*Finance managers of each Business Group are to ensure that: the disposal of the obsolete and surplus property is undertaken in a timely manner and in the most appropriate way; and the disposal of the property obtains the best net outcome for the Commonwealth.'*

4.47 In response to issues raised by Finance in April 2001 on the requirements of an approver under the FMA Act, ANAO obtained additional legal advice from AGS that:

> *In our view, paragraphs 9(1)(a) and 9(1)(b) of FMA Regulation 9 are to be read conjunctively. If there were a situation where there was a conflict between the efficient and effective use of public money and the requirements of the policies of the Commonwealth, then it would be prudent for the particular Commonwealth officer to seek guidance or reconsideration of the policy...........In circumstances where a proposed sale of Commonwealth property does not appear to DOFA to comply with the legislation, policies and principles, it would be the responsibility of DOFA to inform Ministers of the enquiries undertaken (within the context of the FMA Act, Regs and Commonwealth principles and policies) and seek their consent before proceeding with the sale.*

4.48 **Finding**: Finance advised ANAO in April 2001 that its role was to implement a property divestment program endorsed by Ministers and that it: '*was not charged with the role of protecting the overall interest of the Commonwealth*.' ANAO considers that, given the administrative division of responsibility and accountability, Finance is the only agency in a position to ensure that property divestment is consistent with the CPPs and to make an informed judgment as to whether a property sale and leaseback transaction represents efficient and effective use of Commonwealth resources at the time of the transaction.

4.49 The approver of a Commonwealth property sale effectively endorses both the sale of the property and the execution of leases for the property with the proposed purchaser. An inquiry process necessarily involves Commonwealth officers in making comparisons of costs and benefits of alternative options. In the property sale and long-term leaseback transactions reviewed by ANAO it was not apparent that a systematic process of inquiry, as required under the FMA Regs and the *Commonwealth Procurement Guidelines*, was conducted by Finance prior to executing the sale contract and leasing arrangements with the purchasers.

4.50 ANAO's legal advice is that if there is a conflict between the efficient and effective use of public money and the requirements of the CPPs, it would be prudent to seek guidance or reconsideration of the policy. In circumstances where a proposed sale of Commonwealth property does not appear to represent value for money at the time of the sale, it would be good administrative practice for Finance to inform Minister(s) of the inquiries undertaken and seek their consent before proceeding with the sale.

Recommendation No.5

4.51 ANAO recommends that, to provide assurance that the overall interests of the Commonwealth are protected, Finance's approval processes for a property sale and leaseback transaction include the formal consideration of the: Commonwealth Property Disposals Policy; Commonwealth Property Principles; Financial Management and Accountability Act and Regulations; Commonwealth Procurement Guidelines; and the relevant Chief Executive's Instructions.

4.52 ***Department of Finance and Administration response:* Disagree.** Finance has and will continue to consider the Commonwealth Property Disposals Policy, Commonwealth Property Principles, Financial Management and Accountability Act and Regulations, Commonwealth Procurement Guidelines (where relevant) and the Chief Executive's Instructions, given that the tenant agencies have agreed to a lease document in accordance with the Commonwealth Property Principles (Principle 7).

4.53 **ANAO comment:** ANAO considers that in practical terms, Finance is the only agency in a position to ensure that property divestment is consistent with the CPPs, and to make an informed judgment as to whether a property sale and leaseback transaction represents efficient and effective use of Commonwealth resources and is also in the overall interests of the Commonwealth. Finance advised ANAO in April 2001 that it was not charged with the role of protecting the overall interest of the Commonwealth. While noting the department's view, there have been many occasions when Finance has assumed a whole-of-government perspective in an area of common financial management interest. It would not be a case of intruding on the responsibilities of an agency CEO or of 'second guessing' an agency assessment. It would be a prudent means of advising on a divestment from a whole-of-government perspective.

AGSO property sale case study

4.54 The selected tenderer for the AGSO property sought to withdraw its bid after advice of selection but prior to exchange of contracts.[107] This resulted in the Commonwealth accepting a price some $5.6 million less than it would have received had the sale been completed with this preferred tenderer (see Figure 4.4). While Finance requires that a copy of the contract of sale be signed by the tenderer and lodged with the bid, it does not routinely undertake a formal viability study of bidders as part of the tender evaluation or require a surety. Requiring a lodgment fee or preliminary deposit and conducting routine financial checks on tenderers have been raised as good practices in previous audit reports of major asset sales.

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[107] Finance advised ANAO that the preferred tenderer sought the Commonwealth's approval to withdraw and that such approval was agreed by the Delegate.

4.55 The AGSO property was sold to the seventh highest bidder of 11 bids. A binding offer was not lodged by the highest bidder; unresolved issues rendered the second highest bid highly non-conforming; the third highest bidder withdrew after selection; the fourth highest bidder revised its bid downwards during the clarification process; and the lease amendments sought by the bidder lodging the fifth and sixth highest bids were considered unacceptable. This bidder was ranked second in the tender evaluation process after seven of the 11 bids were assessed as commercially unacceptable and excluded from further consideration.

4.56 The second highest bidder was initially excluded from further consideration after clarification was sought on the areas of non-conformance. The tender had a price variation clause[108] and during the clarification process amendments to the lease were also sought. The lease amendments sought by this tenderer were not acceptable to the TEC and the tender evaluation report listed this tender as commercially unacceptable and excluded from further consideration. The clarification process with this tenderer included a form of negotiation by requesting it to vary an aspect of the price variation condition in return for other changes. While the tender was non-conforming, the lengthy clarification process did not resolve the issues.

Figure 4.4

International tender—AGSO Headquarters

Date	*Key events—AGSO property sale*
November 1997	CPC recommended retention of AGSO property.
February 1998	AGSO occupied purpose-built premises costing $108.5 million.
May 1998	Divestment of AGSO property included in 1998–99 Budget and scheduled for 1999–2000.
30 June 1999	AVO book valuation of AGSO property at $90.5 million.
20 September 1999	Lease terms agreed providing 20 year term with no renewal; commencing rental of $13 million per annum; and rent reviews guaranteeing annual increases.
1 November 1999	Finance appointed a firm as sales adviser, based on that firm's proposal of 20 September 1999.
7 January 2000	Marketing of property commenced with calling of international tenders. Generated 117 enquiries leading to 16 inspections.
1 February 2000	AVO market valuation of $135 million. Assumed life of building of 25–30 years and terminal value at end of 20 year lease of $19.7 million.[109]

continued next page

108 The price was contingent on movement in the Commonwealth Bonds 10 year indicator rate; the offer could be rescinded if movements in that rate exceeded given boundaries; and the offer was variable until completion.

109 The life of the building was assessed from completion of the building. The discounted cash flow analysis used as the basis for the valuation was structured to reflect the economic life of the building terminating at the expiration of the AGSO lease and the residual value assessed as a redevelopment site.

Date	*Key events—AGSO property sale*
29 February 2000	Eleven tenders received from eight bidders ranging from \$104 million to \$175 million. Only two tenders were classified as conforming and only one bid was below the market valuation of \$135 million.
27 March 2000	Finance Internal Audit signoff that proper probity has been maintained during the sale process.
5 April 2000	Four bids shortlisted in Tender Evaluation Report (TER) as commercially acceptable, with sale to third highest bidder for \$158 million recommended. Report noted sales adviser assessed terminal value of the property to be \$15 million.
9 April 2000	Minister for Finance and Administration noted his delegate's proposal to sell the property, with the present value of lease payments assessed by Finance to be less than the present value of sale proceeds.
10 April 2000	Preferred tenderer was informed orally that it was the successful tenderer.
12 April 2000	After examining sale documentation in more detail, successful tenderer formally withdrew its bid.
18 April 2000	Supplementary TER recommending sale to seventh highest bidder for \$152.4 million approved by delegate. Contracts exchanged.
20 April 2000	Ten per cent deposit received by Commonwealth and Minister announced successful sale.
31 May 2000	Settlement of sale occurred and 20 year lease executed commencing 1 June 2000. Total cost of sale was \$4.1 million or 2.7 per cent of sale proceeds.
27 July 2000	Firm that acted as sales adviser assessed the terminal value of the property at the end of 20 year lease as \$121.5 million[110] and life of building at 40–50 years.

Source: DAS, Finance and external adviser documentation

Sale completion risk

4.57 To promote the lodgment of binding bids, Finance adopted a practice of requiring a 10 per cent deposit to be lodged by the preferred tenderer <u>within three days of exchange of contracts</u>.

[110] In the calculation of the terminal value prepared by the external advisers, \$39.1 million was included for the cost of refurbishment on termination of the lease and \$46.6 million was also included as the foregone rent for the 2 ¼ years estimated for marketing the property at the expiration of the lease.

4.58 The preferred tenderer in the AGSO property sale withdrew from the sale process after selection. In its report of 5 April 2000, the TEC ranked that tenderer's bid as conforming and the highest-priced tender capable of acceptance. On 9 April, the Minister noted his delegate's intention to sell the AGSO property to this bidder. He was advised that failing the payment of the deposit by the preferred bidder, the property would be sold to the second ranked tenderer assessed at a price $9.6 million less at that time, and if that tenderer also failed to make the deposit, the property would be sold to the third ranked tenderer. The preferred tenderer was verbally advised on the next day that it was the successful tenderer. However, on 12 April the tenderer requested permission to withdraw from the sale process. The grounds for this request were that the tenderer expected to be able to do additional due diligence prior to completion and would require amendments to the lease to secure the funding for the purchase. ANAO notes that a bank guarantee for the amount of the deposit was requested from another bidder for the AGSO property and not this bidder. ANAO considers that Finance should consider the requirement for bidders to lodge a deposit with their bid for property sales. The practice of requiring a lodgment fee or preliminary deposit was also noted in a previous audit of Commonwealth property sales.[111]

4.59 On 13 and 14 April 2000, further exchanges occurred between the legal adviser, Finance and the excluded bidder in clarification of the terms of the tender. That tenderer was given a deadline that it did not meet and the sale proceeded with the tenderer with the second highest price considered by the TEC as capable of acceptance.

4.60 Company credit or business/financial checks are not routinely conducted by Finance on the higher-priced tenders to identify any adverse notations and to confirm financial capability.[112] ANAO has previously recommended that it would be better practice to routinely conduct evaluations of financial capability.[113] In May 2001, the sales adviser for the package sales advised ANAO that:

> *As many property purchases are undertaken with special purpose*

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[111] Audit Report No.20 1996–97, *Selected Commonwealth Property Sales*. The RFT for the sale of two Repatriation General Hospitals required a preliminary deposit of $250 000 to be included with the offer, and the sale of two properties in Singapore in the Overseas property estate of the then DAS included the requirement for a tender fee to be lodged.

[112] In February 1998, prior to finalising the approval of the sale of Packages 1–4, Finance required a probity check for the two purchasers of Package 3.

[113] Audit Report No.20 1996–97, *Selected Commonwealth Property Sales*, Recommendation No. 6, p. 39. In agreeing with the recommendation, the Department of Defence commented that it carries out financial evaluations for significant property sales.

companies with no financial history or standing, any analysis of their ability to settle would have proved inconclusive or misleading. Any decisions made to reject a superior offer on the uncertainty of completion would have exposed the Commonwealth to (at a minimum) extreme criticism and a lack of faith in the process. [The sales adviser] *supports the process utilised and rejects that further risk analysis or formal viability study of bidders would have proven beneficial (as ANAO would note, generally a back up purchaser was also identified in case the preferred purchaser failed to complete).*

4.61 The preferred tenderer's bid was classified as conforming subject to clarifying execution of the contract (as the sale contract lodged with the tender forms were not executed under seal). During the clarification process, the identity of the proposed purchaser(s) was sought from the tenderer. A company name was provided by the tenderer, however, Finance records indicate that the identity of the purchasing entity was still in question after the tenderer had been advised that it had been selected. In contrast, the tenderer referred to above whose bid was excluded had submitted a signed and sealed sale contract which reserved the right to introduce a co-purchaser. Before being excluded, this tenderer was requested to provide a bank guarantee for the deposit. However, no such requirement was imposed on the preferred tenderer or any of the other bidders.

4.62 The RFT for the sale of the AGSO property specified that each tender lodged would remain valid and be irrevocable for 10 weeks. The selected tenderer withdrew as the premise upon which the tender was submitted was inconsistent with the tender conditions. No action was taken against the selected preferred tenderer for withdrawing within the 10-week validity period. Two options available to the Commonwealth in relation to the withdrawn bid were included in the *Supplementary Tender Evaluation Report and Recommendation to Sell* dated 17 April 2000. The option of executing contracts and requiring the selected tenderer to complete the transaction was not favoured by the TEC, as it was considered to potentially involve the Commonwealth in a costly, time-consuming and reputation damaging litigation process. The TEC instead recommended that the bidder be released from its obligations under the contract of sale to purchase the AGSO property.

4.63 A number of instances were identified where exchanges with tenderers or bidders were not documented and legal advice sought by Finance was not obtained in writing. This included the notification to a preferred tenderer in the AGSO property sale; withdrawal of a preferred tenderer in the Package 4 sale; legal advice on the implications of withdrawal by the preferred tenderer from the sale process in the AGSO property sale; and documentation of the unsuccessful auction and subsequent offers in the two direct sales reviewed in the audit. ANAO noted from a review of the documents relating to the highest bid tendered for the AGSO property, that references were made on at least two occasions to the obtaining of legal advice where no written record of that advice was available. The AGS has advised that it is in the interests of all concerned for significant legal advice to be obtained in writing.

4.64 A formal written briefing on the outcome and final negotiations with the preferred tenderer was not provided to the Minister. This contrasts with the practice followed in the sale of the six property packages where formal advice on the tender process was provided to the Minister prior to the execution of the sales contract. Finance advised that the Minister noted his delegate's intention to sell the AGSO property on 9 April 2000 and that the delegate approved the sale on 18 April 2000. Finance advised ANAO that:

> *the original briefing identified a succession of acceptable tenderers should any party not pay the deposit. The final outcome was in line with this approval. DOFA also notes that the Minister's office was advised verbally of the final outcome and in fact the Minister issued a press release.*

4.65 **Finding:** Finance requires that a copy of the contract of sale be signed by the tenderer and lodged with the bid prior to the bid being accepted, but does not routinely conduct financial capability assessments on short-listed tenderers or require bidders to lodge a security with the bid. The selected tenderer for the AGSO property withdrew after advice of selection as preferred bidder by Finance. This resulted in the Commonwealth accepting a price some $5.6 million less than it would have received had the sale been completed with the preferred tenderer.

Recommendation No.6

4.66 ANAO recommends that, on material property sales, Finance institute improved management practices for completion risk through:

(a) evaluating requiring bidders in a public tender to lodge a security with the bid, such as a deposit, bank guarantee or a parent guarantee; and/or

(b) considering the conduct of financial capability assessments on short-listed tenderers, prior to the selection of the successful tender.

4.67 ***Department of Finance and Administration response:***

- **Part (a): Disagree.** Finance has structured all property sales in accordance with professional advice which reflects commercial practice and facilitates the widest number of bids.
- **Part (b): Disagree.** Finance has structured all property sales in accordance with professional advice which facilitates industry bidding and participation.

4.68 **ANAO comment:** The ANAO recommendation is directed at addressing completion risk, one of the criterion included in RFTs for property sales. The tender process for property sales managed by Finance did not require bidders to lodge any finance or security with a tender. In the case of the AGSO sale, the selected tenderer withdrew after advice of selection, resulting in the Commonwealth accepting a price some $5.6 million less than it would have received had the sale been completed with the preferred tenderer.

5. Sale and Long-Term Leaseback Arrangements

This chapter focuses on property sales reviewed by ANAO with leaseback arrangements to the Commonwealth exceeding 10 years, and discusses value for money and whole-of-government considerations in the decision to sell.

Background

5.1 ANAO examined three Commonwealth property sales that realised a total of $380 million where each property had leaseback arrangements in excess of 10 years. Each property had recently been purpose-built in the ACT for the Commonwealth agency occupying the property. The RG Casey Building in Barton and Discovery House in Woden were Office Estate properties included in the packages sold in 1997–98.

5.2 Construction of the RG Casey building was completed in September 1996 at a cost of $161 million.[114] At the time of marketing for sale, it was considered to be the largest office building offered for sale in Canberra. Construction of Discovery House was completed in February 1997 at a cost of $19.9 million. The lease term at the time of sale of these buildings was the balance of the 15 year leases initially entered into on completion of construction.

5.3 The third property reviewed was the AGSO Headquarters at Symonston, included in the SP&I Estate. Construction of the building was completed in 1998. AGSO advised that final expenditure amounted to $108.5 million, comprising construction costs of about $86 million, $11 million for design and consultancy, land cost of $3 million and AGSO fitout costs of $8.5 million.[115]

[114] Comprising $104.7 million for base building construction costs; $21.9 million for consultants agents fees; and tenants (DFAT) fitout costs of $34.3 million.

[115] The valuation report for sale dated 1 February 2000 stated that the cost of the building was $109.5 million including land cost of $3 million and fitout costs of $13 million expended by AGSO. That information was sourced from Finance and the balancing figure for construction cost equates to $93.5 million.

Energy management

5.4 In 1997 a number of policies were promulgated to reduce greenhouse gas emissions,[116] including a commitment to reduce emissions from the Commonwealth Government's own operations through adopting measures to improve energy efficiency. The policy identifies a number of efficiency measures considered essential to any energy management program. One of these measures relates to lease agreements, stating that: '*new lease agreements for buildings should not include any provisions permitting the recovery from the tenant of the cost of energy used in building central services during normal working hours.*'

5.5 The energy policy was interpreted and promulgated to CEOs by the Secretary to the then Department of Primary Industries and Energy in a letter dated 15 April 1998 for Commonwealth Government agencies. Included in the summary of the policy is the requirement that new building leases exclude energy costs from being recovered as an outgoing.[117] The relevant required efficiency measure in the DISR publication is: '*new lease agreements for buildings should not include any provision permitting the recovery from the tenant of the cost of energy used by building central services during normal working hours*.' While the measure states that designated special purpose buildings may be excluded from this requirement if a case can be demonstrated, it appears that property sales with leaseback arrangements to the Commonwealth involving net leases[118] may be in conflict with the policy. The AGSO property lease executed between the private sector owner and the Commonwealth is a net lease in which the tenant is responsible for all electricity charges to the land and buildings. To accord with the policy, the landlord should retain responsibility for the cost of electricity used for central services during business hours.

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[116] Prime Minister announcement of 20 November 1997 *Safeguarding the Future: Australia's Response to Climate Change.*

[117] Department of Industry Science and Resources (DISR) March 2000, *Measures for improving Energy Efficiency in Commonwealth Operations*.

[118] Gross rent leases and net rent leases are discussed in ANAO Report No.53 2000-01, *Commonwealth Management of Leased Office Property,* pp. 55-57 and Appendix 4.

5.6 The lease for the AGSO property is based on a standard lease developed for SP&I Estate properties that has been developed as a net lease. The lease is essentially a triple net lease[119] in that the only expenses of a structural nature for which the tenant is not responsible relate to defects in the structure. In a gross lease, the tenant is responsible for rent and the owner must deliver services to the performance measures specified in the lease. There is profit incentive for the owner to deliver those central services more efficiently. Finance advised ANAO that:

> *In respect of the AGSO building, for operational reasons AGSO wished to contain management control of all facilities within the building. Under the lease AGSO manage and control the building and therefore have absolute control over energy consumed and the sources from which it is obtained. It must also be noted that the AGSO building was constructed with energy efficiency in mind using new technologies to minimise energy use. Therefore energy consumption is minimised in satisfaction of Government policy if AGSO choose to manage the building in an energy efficient manner.*[120]

5.7 DFAT is responsible under the lease for the RG Casey Building for all electricity consumed (other than that consumed by the other lessee in the building). As the owner does not pay for base building electricity, there is no incentive under the lease for the owner to contribute to energy savings programs. In comparison, as tenant IP Australia is responsible for all charges for electricity it consumes on the premises at Discovery House, except for electricity consumed in operating the air conditioning systems or lifts during normal business hours. Finance advised ANAO that the sales process for Packages 1–4 had commenced before the energy policy was announced.

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[119] A gross lease comprises an all up rental and no further contribution is required by the tenant to the building outgoings. A gross/net lease consists of a base rental with a contribution to increases in statutory outgoings over a base year. A net/net lease consists of a base rental and the tenant also pays for all statutory outgoings and other operating expenses of a non-structural nature. A triple net lease generally consists of a base rental and payment by the tenant of all statutory outgoings and other operating expenses inclusive of those of a structural nature.

[120] In May 2001, AGSO advised ANAO that:

> *while there is a potential for conflict to occur, AGSO does not believe that it has occurred in the case of the sale of our building. The intent of the policy is to ensure that the Commonwealth is responsible for its energy usage. The AGSO Building has been designed with energy efficiency in mind. AGSO takes an active role in energy management in operating the AGSO Building to ensure that the building continues to be a model for energy efficient operation.*

5.8 Finding: In 1997, a number of policies were promulgated to reduce greenhouse gas emissions. Included in the summary of the policy relating to the Government's own operations and energy efficiency is the requirement that new building leases exclude energy costs from being recovered as an outgoing. While the measure states that designated special purpose buildings may be excluded from this requirement if a case can be demonstrated, it appears that property sales with leaseback arrangements to the Commonwealth involving net leases may be in conflict with the policy.

Taxation depreciation

5.9 Finance was aware that access to taxation concessions for depreciation allowances[121] can effect both the value of a property and the whole-of-government cost of a property sale. The issue was identified as early as August 1996 when the Domestic Property Task Force (DPTF) reported that the availability of full depreciation allowances on buildings was an important issue for the valuation of major office buildings that could have a material effect on the realisable value of a property. The DPTF saw the need for the issue of taxation treatment to be clarified.[122]

5.10 The issue of access to depreciation allowances for taxation purposes was also raised at a number of meetings of the CPC. Advice on the availability of deductions for depreciation to purchasers under sale and leaseback transactions was sought from legal advisers and property advisers in early 1997. The CPC noted in February 1997 that the predominant view was that, while the taxation implications of depreciation allowances might affect the sale price of properties, it would not affect the saleability. The CPC did not consider it necessary to seek a ruling from the Commissioner for Taxation.[123]

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121 For non-residential rental real estate the following depreciation allowances are available:

- After 19 July 1982, but before 22 August 1984—2.5 per cent per annum;
- After 21 August 1984, but before 16 September 1987—4.0 per cent per annum; and
- After 15 September 1987—2.5 per cent per annum.

122 The report states that:

> *discussions with Tax Officers by the Task Force has indicated that where buildings are fully or nearly fully leased to Government tenants for long periods of time, it is arguable as to whether tax deductibility of depreciation (or interest) would be applicable, or whether the building would be regarded as a finance mechanism rather than an arms-length property transaction. This issue is of fundamental importance to the question of valuation and would need to be clarified, possibly with a test ruling, prior to any final decision-making.*

123 The CPC was provided with an example that indicated some $10.9 million to $12.0 million in depreciation allowances could be expected over the next 11 years for one property (Chandler Building) based on a $40 million property value, (excluding the 2.5 per cent or 4 per cent per annum building allowance).

5.11 Legal advice noted by the CPC in March 1997 indicated that limitations applied to the availability of building depreciation on property formerly owned by the Commonwealth, and that access to deductions was also dependent on the financial arrangements entered into by the purchaser. The advice recommended that a ruling be sought from the Commissioner of Taxation to determine whether deductions would be available to purchasers because the Commonwealth properties were not used for income-producing purposes from the time of construction.[124] Property advisers also noted that it would be appropriate to get specific advice on depreciation allowances for taxation purposes. Commercial practice is to provide depreciation schedules to facilitate financial analysis by investors.

5.12 Depreciation schedules were not provided in the due diligence material made available by Finance to purchasers registering an interest in properties for divestment. A special condition was inserted into Contracts for Sale stating that the Commonwealth, as vendor, makes no statement, warranty or representation as to whether depreciation can be claimed by the purchaser for items included in the sale and that the purchaser acknowledges that it has satisfied itself as to whether or not depreciation can be claimed for items included in the sale for taxation purposes. The joint advisers to the CPC reported in March 1997 that market testing indicated that depreciation schedules should be provided.

5.13 In June 1998, Finance acknowledged that the real estate agents involved in the sale of Packages 1–4 had independently advised that provision of indicative depreciation schedules would have enhanced sale return.[125] Packages 5&6 included two modern buildings (Sydney Central and Casselden Place) and tax treatment was considered to be a major purchaser consideration.[126]

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124 Division 10D provides for deductions on the capital cost of the building where the first use of that building is for income-producing purposes.

125 ANAO also noted that the proposal from the real estate agents engaged to sell the AGSO property considered that the price achieved for the property may be improved through clarification of the status of depreciation and building allowances and eligibility of the new owner to utilise these in a tax-effective manner.

126 For example, the market valuation for sale dated 6 January 1999 for Casselden Place stated that:

> *it should be noted that in the case of Casselden Place, which was completed in 1992, no depreciation allowances have been claimed for capital works or for plant and equipment for tax purposes, and as such unclaimed allowances may be of a significant nature to some specific purchasers. The benefit of unclaimed depreciation allowances have not been included for the purposes of this valuation as the amount applicable may vary from purchaser to purchaser, and no definitive ruling has been obtained from the Australian Taxation Office in relation to this matter.*

Finance advised ANAO that it disagrees with this advice and states:

> *the accounting advice provided to DOFA indicates that a buyer will not as of right be entitled to claim tax deductions in respect of the depreciation of plant and other capital works related deductions (eg. Building amortisation) which have not been claimed by the 'tax exempt' Commonwealth vendor during its period of ownership.*

5.14 Despite identification of the issue, a taxation ruling has not been sought by Finance and it has maintained the position taken by the CPC not to provide depreciation schedules or associated tax advice. Finance advised that it considered that the risks of detailing schedules or advice far outweighed any advantage and that the CPC considered that the market accepted that deductions were available. Finance did not consider taxation implications from a whole-of-government perspective in the sale of property.

5.15 ANAO considers that, as part of the tender evaluation process for material property sales, access to tax deductions through depreciation needs to be considered in conjunction with the realisable value of a property in order to identify the whole-of-government effect of the sale of Commonwealth property. Finance did not obtain advice as to the whole-of-government implication of the sale/leaseback arrangements[127] reviewed in this audit prior to executing sale contracts.

5.16 The impact of taxation depreciation was considered in the two sales managed by OASITO; the first tranche of the sale of the Federal airports that raised $3.31 billion in proceeds[128] and the sale of DASFLEET that raised $407.9 million in proceeds[129]. In the airport sale process, the Commonwealth reserved the right to assess the tax impacts of bids, including financing structures, in such a manner as it considered appropriate. In the sale of DASFLEET, the sale agreement specifically precluded the purchaser from using any taxation depreciation options otherwise available to it, thus maintaining the integrity of Commonwealth tax revenue.

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[127] The Australian Taxation Office has identified in Taxation Ruling 95/30 the factors which would indicate, in some circumstances, that the legal characterisation of a transaction was not that of sale and leaseback, including:

- (a) the intention of the parties as determined from the documentation and surrounding circumstances;
- (b) the lessor has no right to obtain possession of the asset on default by the lessee;
- (c) all the risks and benefits of ownership of the asset are with the lessee after the termination of the term of the lease (this could occur where the lessee was entitled to any excess of the sale price of the asset over the residual value);
- (d) the lease is for a period that is likely to exhaust the remaining useful life of the asset;
- (e) the lessee has a right or option to purchase the asset upon expiration of the term of the lease for less than the market value of the asset; or
- (f) the sale price of the asset to the lessor is substantially in excess of the market value of the asset.

[128] ANAO Report No.38 1997-98, *Sale of Brisbane, Melbourne and Perth Airports.*

[129] ANAO Report No.25 1998-99, *DAS Business Unit Sales—DASFLEET Sale.*

5.17 There is no tax advantage for the Commonwealth participating in property leasing structures. From a financial perspective, at the whole-of-government level a general presumption against leasing would be expected as the Commonwealth can raise finance at a lower rate of interest than the private sector.

5.18 **Finding:** Finance was aware that tax depreciation was an issue affecting the sale price of properties. However, it did not provide prospective purchasers with schedules of depreciable assets for the properties to be divested, which may have enhanced sale proceeds. The joint advisers to the CPC reported in March 1997 that market testing indicated depreciation schedules should be provided. In June 1998, the real estate agents involved in the sale of Packages 1–4 advised Finance that provision of indicative depreciation schedules would have enhanced sale return. Common commercial practice is to provide depreciation schedules to facilitate financial analysis by investors. In addition, Finance did not obtain advice as to the whole-of-government implication of tax depreciation for sale / leaseback arrangements reviewed in this audit prior to executing contracts.

Commonwealth lease costs

5.19 In order to address value for money to the Commonwealth in the decision to retain or sell property, the total cost of the commitments under the lease and the method for financing those lease payments should be assessed against the investment of the potential proceeds from sale. Analysis undertaken for ANAO indicates that, for each of the three property sales reviewed involving long-term leaseback commitments by the Commonwealth, a break-even point could be reached before the end of the lease term, after which the Commonwealth could be paying more for the leaseback arrangement than it could gain from investment of the sale proceeds. The analysis assumes that proceeds from sale are invested for the term of the lease at the Treasury bond rate at the date of sale, and that the Commonwealth has borrowed funds to satisfy the annual lease commitments.[130] The AGSO, RG Casey and Discovery House properties reach a possible break-even point in Years 11,[131] 11 and 8 respectively (see Figure 5.1). At a break-even point, the Commonwealth will have exhausted all of the investment funds from the sale proceeds, including the earnings on invested proceeds. This result accords with that anticipated by the DPTF, that the property divestment process would result in a net increase in total Commonwealth budget outlays in future years (see Chapter 2).

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130 Lease payments are made monthly in advance under the terms of the leases.

131 Breakeven could occur at Year 13 based on projected minimum lease payments.

Figure 5.1:
Break-even analysis for properties sold with leases exceeding 10 years

Property	Term of lease on sale	Break-even point Year[1]
AGSO Headquarters	20 years	11
RG Casey Building	13 years 309 days	11[2]
Discovery House	13 years 278 days	8

Notes
1: Based on re-investment of sale proceeds at the prevailing Commonwealth 10 Year Bond Rate
2: Excludes consideration of a 38 per cent increase in the base rent for the RG Casey Building recently requested by the new owner.

Source: ANAO analysis based on Finance and Reserve Bank of Australia data.

5.20 The leases executed at the time of sale detail the annual rent commitment and the rent review process.[132] In each of the long-term leases reviewed, the commencing rental on sale was above the valuer's assessed market rent for the properties.[133] The lease burden carried by the Commonwealth as a result of the setting of rent commitments above market values is outlined in Figure 5.2.

Figure 5.2:
Lease commitment above market rate for properties sold with leases exceeding 10 years

Property	Rent commitment under sale/leaseback arrangements (psm[1])	Market rent (psm)[2]	Above market lease commitment (pa)[3]	
AGSO Head-quarters	Main Building $426.47 Support Building $333.35	Main Building $350 Support Building $300	$2 152 364	16.5 per cent
RG Casey Building	Storage $100.00 Office $388.00	Storage $100 Office $340	$2 134 560	12 per cent
Discovery House	Storage $96.50 Office $320.68	Storage $80 Office $300	$227 464	6.7 per cent

Notes
1: psm = per square metre
2: Assessed by AVO as property valuer.
3: The lease burden at the commencing rental under the executed leases on sale; pa = per annum

Source: ANAO analysis from market valuations of properties at time of sale.

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132 The Contract for Sale includes a condition for leaseback to the Commonwealth, that on completion the purchaser must grant the vendor the Commonwealth Lease on the terms and conditions contained in the Commonwealth Lease.

133 Each of the leases also includes ratchet provisions that prevent the rental amount from decreasing as a result of the rent review process.

5.21 Principle 7 of the CPPs required Commonwealth agencies to formalise occupancy agreements with conditions and rentals that are market-based. The initial rentals paid under the AGSO property, RG Casey Building and Discovery House leases exceeded market values, included in the market valuations for sale for those properties, by some 17, 12 and 7 per cent respectively. AVO noted in its valuation dated 1 February 2000, that the 'above market rent' paid for the AGSO property accounted for $19.2 million in the assessed $135 million market valuation for sale.

Commonwealth Property Principles—Principle 7

For Commonwealth agencies occupying property owned by another part of the Commonwealth, occupancy agreements (as a substitute for private sector leases) should be formalised between the Commonwealth property owner and the occupying agency. Conditions and rentals should be market-based. All agreements between arms of the Commonwealth should be binding, and transferable on sale of properties. Where such properties are identified for sale, the occupancy agreements should be placed in a form that facilitates completion of the sale.

5.22 Finance indicated that the commencing rental for the RG Casey Building was based on the level of rental and lease term required to justify the construction of the building and that these terms were carried forward to the CTL signed by DFAT in March 1997. The pre-commitment agreement between DFAT and Finance could not be located. However, references were found to a pre-commitment rental amount that is consistent with the commencing rental in the executed lease on sale of the property.[134] The basis for continuing to apply the pre-commitment amount after sale could not be established.[135] DFAT questioned why these lease terms should apply on sale of the property, however, Finance did not allow the commercial terms of the CTL to be varied.[136]

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[134] There are indications that the pre-commitment rental structure was agreed in June 1992 based on $400 per square metre for office areas as at January 1996 with rent reviews bi-annually to market, reflecting a rental of $388 plus $12 per square metre for amortisation of specific building features.

[135] Finance advised DFAT on 31 July 1996 in regard to DFAT's rental obligations that: '*the level of $400 per square metre was set in 1992 and we cannot be certain of its continuing appropriateness. In this regard we propose that $400 m2 is preliminary and a final level would be set after factoring the results of the forthcoming review of Commonwealth properties.'*

[136] The DFAT lease for the RG Casey Building is discussed in ANAO Report No.53 2000–01, *Commonwealth Management of Leased Office Property*. That report states:

> *DFAT indicated that it agreed to the lease only because of the deeming deadline imposed on the Department, and expressed serious reservations about a number of commercial aspects of the final lease. Finance could not agree to vary certain provisions of the lease because it considered that DFAT sought to vary some of the essential commercial terms of the lease, including the level of rent, rent review provisions, lease terms, and arrangements for payment of energy costs, contrary to the fundamental principle of user pays. Finance stated that this would have been detrimental to the Commonwealth's divestment program* (p. 72).

5.23 Before the building was sold, DFAT sought independent legal advice on the lease terms and conditions that would apply on sale. A summary of that advice noted that:

- *there was insufficient time and scope to properly address the issues;*[137]
- *despite their relative importance, the interests of the Commonwealth, as tenant, were not being accorded sufficient attention and were certainly being subrogated to the interests of the Commonwealth in achieving the maximum sale price on the divestment;*
- *the process did not address the necessity to achieve a proper and fair balance in the rights and obligations of the lease parties;*
- *the documentation lacked certainty and did not allow for a clear allocation and management of risk, and*
- *generally, the lease terms and conditions were 'pulled from a shelf' rather than tailored for the circumstances.*[138]

5.24 Finance advised ANAO that it could not agree to the substitution of an alternate lease document proposed by DFAT's lawyers in place of the Government-endorsed CTL[139] and that: '*DFAT's lease was substantially redrafted during negotiations to deal with DFAT's security concerns and a range of other drafting issues that did not go to the key commercial terms. DOFA disagrees with all the assertions contained in DFAT's legal advice.*'[140]

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[137] It was noted that proper consideration should have been given in that the lease was for nearly 50 000 square metres of space for a term of 15 years with rental expenditure alone likely to exceed $300 million and total expenditure of possibly $500 million.

[138] The legal adviser also considered that:

> *there have been a number of difficulties encountered by DFAT with its landlord and, in* [the legal adviser's] *opinion (supported by DFAT's property and legal branches), many have resulted from the department's inability to drive the lease negotiations free from the overriding Commonwealth requirements to maximise the sale price on divestment of the building*; *and the Commonwealth Divestment Program was an exercise where the anticipated income stream was bargained against sale price rather than those accommodation services, and to that extent, the Commonwealth had an internal conflict of interest*.

[139] DFAT advised Finance on 25 November 1997 that:

> *you will be aware that DFAT's agreement to the CTL was in the context of the deeming deadline imposed on us and we continue to have serious reservations about a number of the commercial aspects of the lease which were not able to be re-negotiated. Those reservations are based on concern that the sale and lease transactions were insufficiently driven by commercial standards to ensure best value for money was achieved. In particular, we see no justification for the perpetuation in the lease of the amortisation arrangement after ownership of the building has been transferred to a private sector owner. We are also concerned that the price structure of the rent and car park license components of the lease do not reflect current market values.*

[140] Other issues, including DFAT's security requirements, were satisfactorily resolved and updated in the lease to be executed on sale.

5.25 Two years into the lease of the RG Casey building, issues are arising between DFAT, as tenant, and the owner that indicate shortcomings in the standard commercial lease adopted by the Commonwealth for sale/leaseback properties. The lease specifies the annual rent figure and the Net Lettable Area (NLA) for the premises, but not the breakdown of storage and office areas occupied. Finance advised ANAO that DFAT's lease for the RG Casey Building:

> *provides a sound basis for the charging of lease space and any valuer assessing the market rent would determine the nature of the areas upon which he is assessing the rent in order to determine the market value of the premises leased. The valuer would take into account those areas that are not office space and value them accordingly. This is not a flaw in the lease and is consistent with most major leases. The lease contains detailed drawings of all floors leased and ascertaining the nature of various areas and their classification is straightforward.*

5.26 DFAT advised in November 2000 that it was undertaking a re-measurement of the NLA in the building to identify possible duplicate charging for space and to resolve the definition of areas currently being charged at 'office' rent that DFAT considers are not fit for purpose.[141] DFAT identified that the absence of a rent schedule detailing each of the areas occupied by it and the rental rate applied to those areas in the executed lease may create problems if deficiencies are identified in the original survey. As noted, the lease details the annual rent figure and the NLA for the premises, but not the breakdown of the rental figure by area occupied.

5.27 In May 2001, DFAT advised ANAO that the net lettable area had been re-measured and that the re-measurement, if accepted by the lessor, will result in a reduction in the total net lettable area and a reduction in office space that has been identified as suitable only for storage. DFAT also advised that the new owner had formally notified DFAT that they were seeking a 38 per cent increase in the base rent for the RG Casey Building to $22 723 537.[142]

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[141] A briefing paper prepared by DFAT for discussion with the new owner of the building on 17 November 2000 notes that: '… *recent investigations have identified significant areas of the RG Casey Building (2 760sqm) for which we are paying office accommodation rates ($388psm) as opposed to storage rate ($100psm).*'

[142] Based on a commencing gross rental of $16 395 048 per annum and NLA of 43 218 square metres, DFAT pays $379 per square metre and an annual amortisation payment of $519 996. With the proposed rental increase, DFAT would pay $526 per square metre.

5.28 In the AGSO property lease, a breakup has not been specified for the NLA of the main and support buildings and areas designated as either office or storage space. The rental figure is a total figure for lease of the property. For the RG Casey Building, the NLA has been specified for the building and the premises, however, a breakup has not been included of those areas designated as either office or storage space. In contrast, the Discovery House lease provides both the NLA and detail of the split between office and storage space on each of the floors in the building. ANAO questioned why a consistent approach has not been adopted in the leases. Finance advised ANAO that:

> *the AGSO lease was a whole of land and building lease which is different to a premises lease. Consequently the treatment of the AGSO property will always be fundamentally different to that under the CTL. DOFA reiterates, in respect of the CTL, that a detailed split of NLA is not required and ultimately has no effect on determination of market value for the space leased.*

5.29 Prior to construction, the agency designated to occupy Discovery House entered into an agreement which set the commencing rent based on a 10 per cent return on construction costs. The terms of the rent review process were designed to preserve that rate of return for the life of the lease. The market valuation for the sale of Discovery House highlighted that the 15 year lease had the effect of insulating the investment from any market down turns and that normal market factors would have little initial effect on the value, given the high initial rental and minimum rental clauses. In its September 1997 report reviewing the property sales packages, the sales adviser also noted that the rent was well above the market rates for Woden at the time and that, as the rent reviews for the first six years were to Consumer Price Index (CPI), there was unlikely to be an adjustment to market.[143]

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[143] The Pre-commitment Occupancy Agreement between the then DAS and IP Australia included a 15 month rent free period. The rent free period expired on 1 May 1998 and the lease executed with the private sector owner commenced on 28 April 1998.

5.30 AGSO did not enter into a pre-commitment occupancy agreement with the then DAS prior to construction of its Headquarters building. The rental commitment included in the lease executed on sale was instead based on an assessment of economic rent which was set above market rent. Finance advised AGSO in June 1998 that a capital use charge would be imposed for occupation of the property from 1 July 1998 based on a property valuation as at 30 June 1998.[144] The valuation was provided before the lease terms were set for the property and assumed a 10 year lease to a Commonwealth tenant and reflected the special purpose nature of the building with its large area of laboratory space. The capital use charge was originally assessed at $12 million per annum and assumed that the tenant was responsible for all charges associated with a major commercial office building. The commercialisation process initially required the replacement of the capital use charge imposed by Finance on SP&I Estate properties with market-based rents and occupancy agreements.

5.31 In November 1998, the capital use charge was reduced to $10.925 million per annum based on a revised capital cost of $95 million.[145] This revised charge was considered to reflect the market rate and was calculated on the net rental an owner would anticipate in order to generate a return of 11.5 per cent.[146] This was the charge actually levied by Finance from AGSO's occupation of the property until commercial lease terms became effective. The lease terms had not been finalised when AVO provided a valuation as at 30 June 1999, in which the market rental was assessed at $14 million per annum gross and $12 million per annum net. This assessment assumed a rental period of 15 years with a five-year option.

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[144] AGSO occupied the building from February 1998. The divestment process commenced before finalisation of the lease.

[145] Excluding the tenant fitout costs of $13 million.

[146] The AVO stated that: '*in essence the Capital Use Charge of a purpose built building equates to the current market rental less all outgoings such as statutory charges, air conditioning running and maintenance costs, likely repairs and maintenance, grounds maintenance, common area cleaning and security.*'

5.32 As AGSO did not subsequently require all the space available in the complex, it sub-let about five per cent of the total area to two Commonwealth agencies. Both sub-leases commenced in March 2000, prior to the sale of the property. One lease was for five years with options for two extensions of three years each, and the second was for eight months with no renewal option. In May 2001, AGSO advised ANAO that:

> *AGSO fully occupied the building when we occupied it in 1998 and was totally responsible for all property related costs. Following changes to the administrative arrangements orders and changes in budget appropriation AGSO's staff reduced. These staff reductions had no impact on property costs. Staff were relocated so that vacant space could be consolidated. This provided an opportunity to offset some of the property costs by subletting the vacant space. Private sector tenants were not sought because of competitive neutrality concerns. The subletting of the space in AGSO reduced the total property cost to the Commonwealth as our sub-tenants … both came from commercially leased space.*

5.33 AGSO advised ANAO that it agreed to match the rents paid by these agencies in other commercial premises they occupied at Civic and Woden in the ACT. The market valuation prepared for sale on 1 February 2000 assessed that $350 per square metre was an appropriate sustainable market rental rate for the building, having regard to the market evidence and the property characteristics.[147] However, AGSO charges its sub-tenants only $250 per square metre, under gross leases in which the agencies have no further financial obligation, compared with the net lease position in the lease between AGSO and the owner. The rent AGSO negotiated with tenants sub-leasing space in the complex is some 29 per cent below market rates and some 41 per cent below that paid by AGSO under the Head-lease.

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[147] This equated to an assessed net market rental rate for the property of $10 929 560 per annum. The executed lease does not include a reference to the NLA of the property or a breakdown between office space in the main building and storage space in the support building (storage annex) to allow a calculation of the actual rate being paid for office and storage space. The commencing rental rate in the executed lease is $13 082 145 per annum. Extrapolation of figures in the discounted cash flow analysis from the valuation for sale indicates the amounts charged for office and storage space equate to $426 and $333 per square metre respectively.

5.34 **Finding:** ANAO analyses of the whole-of-lease-term costs for sale and long-term leaseback of property found that they could result in a potential negative financial return to the Commonwealth within the lease period. The AGSO property and RG Casey Building both reach a possible financial break-even point in Year 11 and Discovery House in Year 8, after which the Commonwealth could be paying more in rent than it could receive if it invested the sale proceeds at the Commonwealth Treasury Bond rate.

5.35 The CPPs required Commonwealth agencies to formalise occupancy agreements with conditions and rentals that are market-based. The initial rentals paid under the AGSO property, RG Casey Building and Discovery House leases exceeded market values, included in the market valuations for sale for those properties, by some 17, 12 and 7 per cent respectively. In May 2001, DFAT advised ANAO that the net lettable area had been re-measured and that the new owner had formally notified the Department that they were seeking a 38 per cent increase in the base rent for the RG Casey Building to $22 723 537. The rent AGSO negotiated with tenants sub-leasing space was some 29 per cent below market rates and some 41 per cent below that paid by AGSO under the Head-lease.

AGSO property sale and leaseback

5.36 The financial evaluation examined in this section of the audit report considers whether it is preferable to continue to own property or undertake a sale and leaseback transaction. A financial evaluation considers the implication from the Commonwealth's budgetary position rather than from society's economic viewpoint of what level of resources are used in the public or private sectors. The economic evaluation compares the expected rates of return on an investment with the required risk-adjusted returns to determine whether the asset, in this case property, should be retained or sold (see Chapter 2).

5.37 The potential negative impact of property sales on the Budget was raised by the DPTF in August 1996 when it examined the effect on the total Budget of applying different hurdle rates. It reported that the higher the hurdle rate, the greater the number of properties to be divested and the greater the revenue generated from property sales. On the other side, however, it noted that the higher the incidence of divestment, the more significant the withdrawal of investment from property by the Commonwealth and the more negative the effect on total Budget outlays in future years.

5.38 Assuming the net proceeds from sale of the AGSO property are invested for 20 years and funds are borrowed to meet monthly rental commitments over that period,[148] the Commonwealth would require investment at an interest rate of some 9 per cent over this entire period to break-even.[149] The 10 year Treasury bond rate at the time of sale was 6.16 per cent[150] which equated to the Commonwealth's actual cost of funds with zero risk. The DOF Finance Circular 1992/3 'Benchmark Discount Rate to be used in Cost-Benefit Analysis' notes that:

> *There are specific exceptions where a lower discount rate, notably the weighted average yield on the most recent Treasury Note tender (for projects under a year) or the long-term Treasury Bond rate (for projects over a year) would be appropriate. These cases, set out in Chapter 10 of the Handbook* [of Cost-Benefit Analysis, AGPS 1991],[151] *occur when the intended action has a cash flow which is known with virtual or complete certainty and is not subject to any significant amount of risk, such as altering the timing pattern of agreed disbursements or the comparison between leasing and purchasing. In these instances, the decision is not an investment decision as such, but rather the intention is to determine the minimal cost to the Commonwealth budget of a particular course of action.*

5.39 Figure 5.3 illustrates the point at which the net investment return from investing proceeds from the sale of the AGSO property could meet the cumulative rental commitments under the leaseback arrangement to the Commonwealth. Beyond this point the cumulative rental outlays for the property outstrip the value to the Commonwealth of the sale proceeds and any earnings from their reinvestment.

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148 Lease payments are payable monthly in advance. Funding of lease payments has been assessed by ANAO using the 30 day Treasury Note rate.

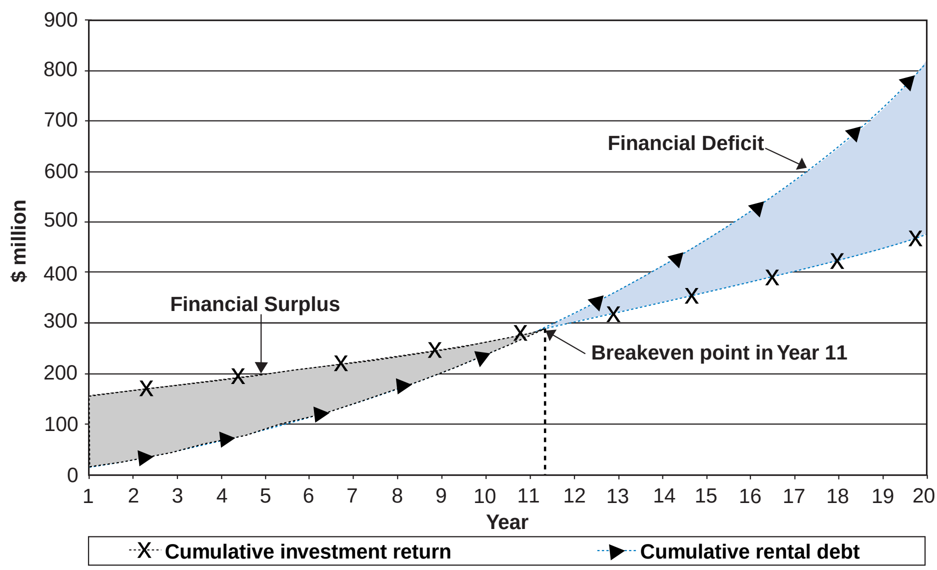
149 Based on applying historic Consumer Price Index movements to projected lease commitments. This figure would be 7.70 per cent based on minimum rental growth.

150 *Reserve Bank of Australia Bulletin* October 2000. The bond rate has subsequently fallen below 5.0 per cent.

151 *The decision to lease or buy a piece of equipment can also be thought of as involving a comparison of alternative timing patterns for the same or similar payments. Conceptually, the choice is between borrowing a larger amount up front in order to purchase the item or alternatively making periodic payments—either as an ordinary cost expense or through a series of smaller borrowings. In these cases also, it is important to use a discount rate which approximates as closely as possible the Commonwealth's actual cost of funds (ie Treasury bond rate or a short-term borrowing rate). If instead an 8 per cent discount rate is used, the result will usually be a bias in favour of the leasing alternative. That is, with 8 per cent real typically exceeding the Government's direct cost of borrowing, the cost of the later-occurring lease payments will be inappropriately reduced relative to the cost of the early-occurring 'buy' payments.* p. 89.

Figure 5.3:

Financial evaluation of AGSO property sale—Breakeven point analysis based on reinvestment of sale proceeds and projected rental costs



Notes:

1: Rental growth based on a 20 year average for the CPI (All Groups) for Canberra calculated from June 1980 to June 1999 and includes the cost of funding monthly payments in advance by the Commonwealth at 30 day Treasury Note rate.

2: Assumes investment of sale proceeds for 20 years at May 2000 Commonwealth 10 year Treasury bond rate.

Source: AVO and ANAO analyses of Finance records

5.40 Finance advised its Minister in April 2000 that the present value of the maximum AGSO lease payments over the 20 year term was $193.2 million and that the present value of the sale proceeds invested at eight per cent per annum over the same term was $236 million, indicating a positive NPV of $43 million. This was based on the bid price at selection of the preferred bidder, excluding sales costs. To ensure that the Commonwealth financial position is maximised, the objective in a sale/leaseback property transaction is to negotiate a contract with the preferred bidder that delivers the highest possible positive NPV. ANAO considers that the present value of the sale proceeds at the time of sale should have been presented as the net sale proceeds, as opposed to the gross sales proceeds.

5.41 The Tender Evaluation Committee for the AGSO sale reported that the opportunity cost of reinvesting the sale proceeds over 20 years at the Social Opportunity Cost of Capital funding rate of 15 per cent amounted to $857.1 million. The actual long term Commonwealth risk-free investment rate is essentially the 10 year Treasury bond rate.[152] ANAO estimated that the sale transaction could result in a negative NPV of $95 million when the net sale proceeds are compared with the possible lease payments over the 20 year lease term, based on the net sale proceeds of $148.6 million. The lease commitments include the costs of funding the monthly payment in advance of the lease payments and projected annual rent increases based on historic movements in the CPI.[153] The NPV would be negative $49 million based on the minimum lease payments over the 20 year lease.

5.42 ANAO considers that advice on the outcome of the transaction may have been better to reflect:

- the costs of funding the monthly payment in advance of the lease commitments over the 20 year term of the non-cancellable lease;
- the on the day 10 year Treasury bond rate of 6.16 per cent (or an appropriate moving average) at the time of sale rather than an interest rate of 8 per cent; and
- that the stated present value for the lease payments may not be the maximum commitment for the Commonwealth, as the calculation is based on an annual 3 per cent rental increase, whereas the lease provides for larger increases where the movement in the CPI exceeds 3 per cent or the rise in the assessed market rate.

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[152] A theoretical treatment of the underpinning of risk in the public sector is outlined in the DOF Discussion Paper of November 1987 *The Choice of Discount Rates for Evaluating Public Sector Investment Projects*. DOF notes that Samuelson (1964) and the first of the Arrow and Lind (1970) theorems detail that public sector projects should be assessed as if they were risk free.

[153] These figures are based on the ANAO applying the average movement in the CPI (All Groups) for Canberra figure over the 20 years ending June 1999 of 5.62 per cent, as available at the point of tender evaluation. The movement in the CPI (All Groups) for Canberra for the 12 month period ending 30 June 2001 was an increase of 6 per cent.

5.43 **Finding**: To ensure that the Commonwealth financial position is maximised, the objective in a sale/leaseback property transaction is to negotiate a contract with the preferred bidder that delivers the highest possible positive NPV. ANAO estimated that the AGSO property sale transaction could result in a negative NPV of $95 million when the net sale proceeds are compared with the possible lease payments over the 20 year lease term. The lease commitments include the costs of funding the lease payments, and projected annual rent increases were based on historic movements in the CPI. The NPV would be negative $49 million based on the minimum lease payments over the 20 year lease. Finance calculations, in advice to the Minister in April 2000, indicated a positive NPV of $43 million. This was based on the preferred bidder's tender price that was not achieved; excluded sale costs; and assumed a re-investment rate of Commonwealth funds of 8 per cent rather than the prevailing Commonwealth long term bond rate of some 6 per cent. Also, the calculations did not fully reflect funding of rental commitments payable monthly in advance or the provisions for rental increases over the 20 year period of the lease above the minimum annual 3 per cent increase.

Property lease

5.44 In February 1999, Finance circulated to the SP&I Estate portfolio a draft Memorandum of Understanding (MoU) and draft whole of land and building lease developed by its legal advisers. The MoU was to be treated as binding between the arms of the Commonwealth while the properties remained in Commonwealth ownership. The leases were developed to govern the relationship between the Commonwealth as tenant and the new owner in the event of sale of the properties. The terms and conditions of the lease were to be market-based. Comments on the lease documentation were required by 3 March 1999.

5.45 AGSO received the draft MoU and lease on 17 February 1999 and sought its own legal advice on the proposed terms and conditions. On 2 March 1999, AGSO responded to Finance highlighting that it would incur additional costs under the lease and sought Finance's confirmation that budget supplementation would be provided for any additional rental commitment. It also provided Finance with a copy of the legal advice, which commented that the: '*lease is drafted heavily in favour of the landlord. Given that this is a whole of the land and building lease for a single tenant in a purpose-built facility, this weighting is inappropriate as it places substantial risk on AGSO.*'

5.46 On 20 September 1999, Finance and AGSO signed a Heads Of Agreement (HOA) committing to enter into a commercial lease arrangement for the building. The HOA was received by AGSO on 16 September and was required to be signed and returned to Finance three working days later. The covering letter included a condition that if the HOA was not returned by that date, Finance deemed that the terms were accepted by AGSO. The HOA specified the 20 year term, rent review process and commencing rental. The commencing rental of $13 million per annum was listed as the 'valuer's assessed market rent'.

5.47 AGSO advised ANAO that it committed to the lease provisions in the HOA on the basis that Finance had agreed to provide supplementary budget funding equal to the annual supplement and that the letter seeking its agreement to the terms included a deeming provision.[154] AGSO advised that it did not seek advice on whether the rent, rent review, or lease terms were appropriate, as it considered Finance had already engaged expert advice to determine this and that AGSO was provided only a short timeframe to respond.

5.48 Under the HOA signed in September 1999, the parties agreed that the pro-forma copies of the lease and lease MoU would govern AGSO's occupation of the land. The parties agreed to negotiate the remaining terms and conditions of the documents in accordance with the proformas developed, and to execute the documents within 28 days. The HOA stated that if terms and conditions were not agreed by then, AGSO would be deemed to have agreed to the terms and conditions as outlined in the proforma documents, and that the Property Group would have authority to complete the Schedules to those documents.

5.49 A number of the conditions in the lease executed on sale of the property, which were essentially derived from the draft proforma lease circulated by Finance in September 1999 for use by occupants of SP&I properties, distinguish it from the standard lease terms entered into for commercial office properties. These include:

- a lease exceeding 10 years—20 year term with no option for renewal;
- rent reviews providing for an increase of at least 3 per cent per annum for the duration of the lease;
- the tenant is responsible for operating expenses, including the landlord's insurance and landlord's costs of the management of the land and building;

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[154] Finance advised ANAO that AGSO authorised Finance to sign the lease on behalf of AGSO in the MoU between AGSO and Finance dated 11 January 2000.

- the tenant to pay all statutory charges;
- the tenant to replace floor coverings in the building, to paint and treat the interior and exterior surfaces of the building, and to keep the building watertight;
- the tenant must keep the land and building in good repair and condition and provide to the landlord for approval a general maintenance program;
- the tenant is responsible for repair and maintenance of plant in accordance with a program approved by the landlord; and
- the landlord does not warrant at commencement that the land and building is suitable for any purpose, may be used for the permitted use, is free from contaminants, asbestos or hazardous substances, or complies with official requirements (given the disclaimers by the Commonwealth in the contract for sale this has the effect of shifting the risk back to the Commonwealth).

5.50 During evaluation of tenders in April 2000, the sales adviser managing the AGSO sale assessed the terminal value of the property to be $15 million, which essentially reflected that the 20 year lease represented the economic life of the property. This assessment was recorded in the Tender Evaluation Report. After the sale, that sales adviser re-assessed the terminal value to $121.5 million in July 2000, based on an economic life of the building of 40 to 50 years. Professional advice on the nature of the AGSO property lease was not obtained by either Finance or AGSO until after the property was sold. Finance advised ANAO in April 2001 that both the sales adviser for the AGSO property sale and Finance always considered the lease to be an operating lease and that additional professional advice was sought after ANAO raised concerns. ANAO concurred with the Finance position that it was an operating lease for financial statement purposes.

5.51 AGS provided ANAO with legal advice on the precise nature of the transaction entered into by the Commonwealth in the sale and leaseback of the AGSO property and the practicality and cost to the Commonwealth of surrendering the lease. It concluded that, from the point of view of an investment, most risk is placed upon the tenant (AGSO) as the only potential expenses to which the owner is exposed are for repair of structural defects and replacement of plant. As it is a new building, it was considered likely that there would be few structural repairs necessary during the term of the lease and damage from outside forces are likely to be covered by insurance paid for by the tenant. There are also likely to be practical difficulties for the tenant in establishing that plant is irreparable and should be replaced. The tenant will be bearing the cost of running aging or obsolete equipment and the landlord is likely to wish to postpone its replacement as long as possible. The separation of maintenance and replacement responsibility for plant between the tenant and owner leaves open for dispute the manner in which plant will be assessed as irreparable.

5.52 AGS advised ANAO that during the life of the lease the rent is likely to be the main determinant of realisable value. It considered that AGSO, as tenant for 20 years, is actually preserving the realisable value of the property, during the lease. Further, the rent review process essentially retains the value of the lease payments, guaranteeing CPI and market increases and not allowing decreases in lease payments.

5.53 The way in which the AGSO property was packaged for sale and leaseback to the Commonwealth made it an attractive investment opportunity for prospective purchasers. As a financial investment it offered:

- a net rent lease where, in addition to rent, the tenant takes responsibility for all the landlord’s periodic outgoings, including land tax, insurance and management expenses;
- an income stream underwritten by the Commonwealth with AGSO as tenant;
- a guaranteed annual increase of at least 3 per cent on rental income, even if inflation and market rents increase at a lesser rate or actually fall;
- preservation of the capital value of the property through the Commonwealth commitment to a 20 year lease period; and
- restricted exposure, as the only potential expenses for the landlord are repairs for structural defects and replacement of plant.

5.54 The Commonwealth’s net cash outlay for the AGSO property could be as high as $265 million at the end of the 20 year lease.[155] The cash outlay could be $152 million assuming minimum contractual lease payments. The sale of properties with long-term leases in place has provided the purchasers with guaranteed cash flows at high yields over long periods.

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155 Assuming a breakeven point of year 11, the net cash outlay for rental payments is the sum of annual rental commitments under the lease from year 12 to year 20, excluding funding costs and with rental increases based on historic movement in the CPI (All Groups) for Canberra to June 1999.

5.55 **Finding:** ANAO's legal advice is that a range of the risks of ownership for the AGSO Headquarters has been transferred to AGSO, as tenant, with only some of the benefits. It does not appear that the level of risk taken on by the Commonwealth (as represented by AGSO) under the terms of the lease has been appropriately reflected in the agreed rental price.

5.56 Finance did not obtain professional advice on the nature of the lease for the AGSO property at the time of lease commitment to ensure that the sale and leaseback arrangements would be properly characterised as a property sale rather than a finance transaction. During evaluation of tenders in April 2000, the sales adviser managing the sale assessed the terminal value of the property to be $15 million which essentially reflected that the 20 year lease represented the economic life of the property. After the sale, that sales adviser re-assessed the terminal value to $121.5 million in July 2000, based on an economic life of the building of 40 to 50 years. Finance advised ANAO in April 2001 that both the sale adviser for the AGSO property sale and Finance always considered the lease to be an operating lease and that additional professional advice was sought after ANAO raised concerns. ANAO concurred with the Finance position that it was an operating lease for financial statement purposes.

5.57 The Commonwealth's net cash outlay for the AGSO property could be as high as $265 million at the end of the 20 year lease (or $152 million assuming minimum contractual lease payments) based on historic movement in the CPI (All Groups) for Canberra to June 1999. The sale of properties with long-term leases in place has provided the purchasers with guaranteed cash flows at high yields over long periods.

Recommendation No.7

5.58 ANAO recommends that Finance include an appropriate whole-of-lease assessment of value for money in advice to the delegate for approval on material sale and long-term leaseback transactions to ensure the financial interests of the Commonwealth are protected.

5.59 ***Department of Finance and Administration response:*** **Disagree.** The application of the CPP includes the appropriate whole-of-lease assessment.

5.60 **ANAO comment:** In order to address value for money to the Commonwealth in the decision to retain or sell property, the total cost of the commitments under the lease and the method for financing those lease payments should be assessed against the investment of the potential proceeds from sale (see paragraph 5.43). Analysis undertaken for ANAO indicates that, for each of the three property sales reviewed involving long-term leaseback commitments by the Commonwealth, a break-even point could be reached before the end of the lease term, after which the Commonwealth could be paying more for the leaseback arrangement than it could gain from investment of the sale proceeds. At a break-even point, the Commonwealth will have exhausted all of the investment funds from the sale proceeds, including the earnings on invested proceeds. This result accords with that anticipated by the Domestic Property Task Force in 1996, that the property divestment process would result in a net increase in total Commonwealth budget outlays in future years.

Canberra ACT
1 August 2001

P. J. Barrett
Auditor-General

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