

Audit Report No. 4, 2001–2002

Commonwealth Estate Property Sales

Department of Finance and Administration

Background

- 3.1 In the 1996–97 Budget context, a set of Commonwealth Property Principles (CPPs) was endorsed by the Government, setting the framework for decisions to retain or dispose of Commonwealth property. Basically there were two tests applied in the divestment: (a) was it in the national interest to own rather than lease properties; and (b) did the proposed sale meet the hurdle rate?¹
- 3.2 The Government decided that all properties that did not meet the criteria laid down in the CPPs should not be owned by the Commonwealth.² A Commonwealth Property Committee (CPC) was established to implement the CPPs and to independently advise the responsible Minister on the whole-of-government management and coordination of the strategy for the divestment of property no longer to be owned by the Commonwealth.³

1 ANAO, Audit Report No. 4, *Commonwealth Estate Property Sales*, Department of Finance and Administration, 2001–2002, Commonwealth of Australia, pp.27–32, 36–37.

2 ANAO, Audit Report No. 4, 2001–2002, pp. 36–37.

3 ANAO, Audit Report No. 4, 2001–2002, p. 36.

- 3.3 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)—valued at \$1.254 billion—was the largest component; followed by the Special Purpose and Industrial (SP&I) Estate (\$694 m); and Public Interest Estate (\$385 m).⁴
- 3.4 Review of the domestic estate by the CPC began during 1996–97 with the assessment of individual properties within the Office Estate against the CPPs which stated that the Commonwealth should own property only where the long-term yield rate exceeds the social opportunity cost of capital or where it is in the public interest to do so. The divestment strategy recommended by the CPC was endorsed by the Government in April 1997 and involved the divestment of 57 (later 59) Office Estate properties over a three-year period.⁵ The aggregate book value of the properties identified for divestment was \$1.05 billion as at 30 June 1996.⁶ 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 grew.
- 3.5 In implementing the divestment program, the Department of Finance and Administration (DOFA) relied on the private sector to manage the sales process.⁷ 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 the Property Group of DOFA.

The audit

- 3.6 The Australian National Audit Office (ANAO) reviewed the sale of properties from that portion of the domestic property estate managed by DOFA and identified for sale in April 1997, via a three year divestment strategy of the Commercial Office Estate. DOFA advised ANAO in April 2001 that its role was to implement a

4 ANAO, Audit Report No. 4, 2001–2002, p. 27.

5 ANAO, Audit Report No. 4, 2001–2002, pp. 27, 30.

6 The book values were the basis on which the rates of return were initially calculated. ANAO, Audit Report No. 4, 2001–2002, p. 32.

7 ANAO, Audit Report No. 4, 2001–2002, p. 47.

property divestment program endorsed by Ministers and that it was not charged with the role of protecting the overall interest of the Commonwealth.⁸

3.7 Within this audit mandate, ANAO felt it was quite appropriate to review:

- the advice given to ministers, in terms of its completeness and accuracy; and
- the financial consequences of the advice given and taken.

3.8 The audit focused on the sale of nine properties in seven case studies, with a total value of \$619 m, and considered whether the property sale represented value for money to the Commonwealth.⁹

Audit findings

3.9 Inter alia, Audit Report No. 4, *Commonwealth Estate Property Sales* found that:

- Total gross proceeds from the Office Estate properties sale included in the three year divestment program were \$983m as at April 2001, with three of the 59 properties remaining unsold.¹⁰
 - ⇒ The sales program was successful in that total proceeds to April 2001 have exceeded revenue targets by \$130m or 15 per cent.¹¹
- One-quarter of the total properties recommended for divestment were packaged, and these realised 85 per cent of the total sale proceeds.¹² Most material properties reviewed in the audit were sold at, or above, the final market value at the time of the sale.¹³
 - ⇒ The majority of the bids for the packages, however, were categorised as non-conforming.
 - ⇒ Some of the non-conforming bids were successful purchasers.¹⁴

8 ANAO, Audit Report No. 4, 2001–2002, p. 14.

9 See Table 1.3 in ANAO, Audit Report No. 4, 2001–2002, p. 33.

10 See Table 1.3 in ANAO, Audit Report No. 4, 2001–2002, p. 33.

11 ANAO, Audit Report No. 4, 2001–2002, p. 55.

12 See Table 1.3 in ANAO, Audit Report No. 4, 2001–2002, p. 55.

13 ANAO, Audit Report No. 4, 2001–2002, p. 13.

14 ANAO, Audit Report No. 4, 2001–2002, p. 85.

- 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.¹⁵
- 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 m in the event that interest rates increased.
 - ⇒ DOFA 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.¹⁶
- DOFA did not conduct financial capability assessments on short-listed tenderers or require bidders to lodge a security with the bid.
 - ⇒ As a result, when the selected tenderer for the AGSO property withdrew after being advised of its success, the Commonwealth ended up accepting a price some \$5.6m less than it would have received had the sale been completed with the original choice.¹⁷
- The cost of sales was estimated by DOFA as \$20.6m or 2.1 per cent of sale proceeds.¹⁸
- The cost of legal services provided for the sale of the packaged properties was estimated as \$3.6m.¹⁹

Committee's concerns

3.10 At the public hearing, the Committee raised the following issues.

- The high level of disagreement between ANAO and DOFA.
- Among the Committee's concerns was DOFA's rejection of all seven audit recommendations because it considered 'the concepts that underpin the report are fundamentally flawed'.²⁰ ANAO, on the other hand, maintained that its

15 ANAO, Audit Report No. 4, 2001–2002, p. 79.

16 ANAO, Audit Report No. 4, 2001–2002, p. 86.

17 ANAO, Audit Report No. 4, 2001–2002, p. 98.

18 ANAO, Audit Report No. 4, 2001–2002, p. 58.

19 ANAO, Audit Report No. 4, 2001–2002, p. 71.

20 ANAO, Audit Report No. 4, 2001–2002, p. 21.

recommendations were ‘framed to achieve improved administrative practices for future property sales’.²¹

- The basis of DOFA’s advice to the Government on the hurdle rate of 15 per cent—an issue of major difference between ANAO and DOFA were examined by the Committee.
- The committee also examined DOFA’s reported comment to ANAO that, while its role was to implement Government decisions for the divestment of property, it ‘was not charged with the role of protecting the overall interest of the Commonwealth’.²² The Committee wanted to examine this more fully.

3.11 Finally, the Committee examined the management of the sale process including the sale and leaseback arrangements.

Commonwealth interests

3.12 ANAO reported that DOFA had stated that its role was to implement Government decisions for the divestment of property: it was not charged with the role of protecting the overall interest of the Commonwealth.²³ In previous sales of Commonwealth assets, DOFA had 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 conformity requirements.²⁴ In the sales being reviewed by ANAO, DOFA had obtained a market valuation of the property to establish a best estimate of the potential sale price. A valuation had also been sought for each package of properties.

3.13 ANAO maintained that for the sales of Commonwealth estate properties:

...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

21 ANAO, Audit Report No. 4, 2001–2002, p. 21.

22 ANAO, Audit Report No. 4, 2001–2002, pp. 52, 92.

23 ANAO, Audit Report No. 4, 2001–2002, p. 52.

24 ANAO, Audit Report No. 4, 2001–2002, p. 53.

of retention if this provided a greater financial benefit to the Commonwealth.²⁵

3.14 Five of the six packages sold above market value, while five of the 15 properties included in the packaged property sales were sold at notional prices below the current market valuation. During the sale process, DOFA 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.²⁶

3.15 These transactions led ANAO to conclude that in the property sale transactions audited:

...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...a further decision could include that the property to be sold ...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.²⁷

3.16 At the public hearing, DOFA officers were at pains to correct the impression that it was not 'protecting the overall interest of the Commonwealth'. The Committee was directed to paragraph 4.42 of the Audit Report No. 4, where DOFA had advised ANAO that:

DOFA's role was to implement the Cabinet decisions to divest property in accordance with the Commonwealth Property Committee (CPC) reports. ...The overall interests of the Commonwealth were considered in the development of the Commonwealth Property Principles (CPP) and the CPC's implementation. Each occupying

25 ANAO, Audit Report No. 4, 2001–2002, p. 53.

26 ANAO, Audit Report No. 4, 2001–2002, pp. 54–55.

27 ANAO, Audit Report No. 4, 2001–2002, p. 89.

Department was involved in negotiating leases and thus ensuring the operating and financial arrangement for their agency.²⁸

3.17 DOFA added: 'I do not want it left on the record in any way that Finance does not believe it has a whole of government responsibility for value for money decisions. We do, and we treat that responsibility very seriously'.²⁹

3.18 DOFA believed that the Government achieved value for money because:

At the point of adopting that hurdle rate of return, it made a value for money judgment. That value for money judgment was this: it would not retain property, unless there was a public interest reason for doing so, that had an internal rate of return of less than the hurdle. So by the government's standard of a hurdle rate, the fact that properties that were sold did not achieve the hurdle rate meant that by definition the government achieved value for money under its criteria.³⁰

3.19 The Committee noted the comment that DOFA saw its role as protecting the overall interest of the Commonwealth, although it was mindful of the audit view that a whole-of-life evaluation should have been made. The Committee firmly believes that DOFA is the only agency best positioned to:

- ensure that property divestment is consistent with the CPPs;
- make an informed judgment as to whether a property sale and leaseback transaction represents efficient and effective use of Commonwealth resources; and
- decide if a transaction is in the overall interest of the Commonwealth.

Divestment strategy

3.20 The Committee was interested to know the basis of the hurdle rate of 15 per cent used as the basis for the divestment strategy.

28 ANAO, Audit Report No. 4, 2001–2002, p. 89.

29 E. Bowen, DOFA, *Transcript*, 31 May 2002, p. 34.

30 Bowen, *Transcript*, 31 May 2002, p. 38.

A hurdle rate, based on DOFA advice, was central to the Government decision to divest itself of estate properties.³¹ As DOFA explained at the public hearing:

It was not open to Finance to arbitrarily change or take a view on a particular hurdle rate that had been adopted by the government. The government adopted that rate in 1996 when interest rates, the cost of funds, were substantially higher than they are today. It applied a risk premium to that cost of funds to arrive at a rate between 14 and 15 per cent—it was actually a band. The government has recently, in the latest budget in fact, adopted a revised hurdle rate. That is a rate of 11 per cent. That rate is aligned with the government's capital use charge rate and it is the rate that the government has said it will use in determining the appropriateness of long-term investment decisions.³²

3.21 In 1999 and 2000, DOFA commissioned two consultant reports to help determine the revised hurdle rate.³³ The 1999 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'.³⁴ The July 2000 report suggested that 'a wide range for the property hurdle return is appropriate, with the upper bound at approximately 11%'.³⁵

3.22 When questioned on how the hurdle rates were developed, DOFA explained that the 2002–2003 hurdle rate was based on:

...the 10-year average of the 10-year bond rate, to get a bit of stability into it. You are not investing by hopping into the market and hopping out. They are long-term decisions, whether you buy or whether you sell and rent. The government has adopted a rate which is based on that 10-year average of the long-term bond rate. It has added to that a premium for risk based on the 10-year average of the premium obtained in the equity market. It

31 See the diagram in ANAO, Audit Report No. 4, 2001–2002, p. 38. In the audit report, ANAO outlined how the final hurdle rate was derived before its final adoption by the Government.

32 Bowen, *Transcript*, 31 May 2002, p. 36.

33 ANAO informed the Committee that the external reports were prepared by Access Economics, B Jackson, ANAO, *Transcript*, 31 May 2002, p. 46; ANAO advice dated 25 June 2002. ANAO, Audit Report No. 4, 2001–2002, pp. 40–41.

34 ANAO, Audit Report No. 4, 2001–2002, p. 40.

35 ANAO, Audit Report No. 4, 2001–2002, p. 41.

is not perfect, but it is a good approximation for a risk weighting on a broad spectrum of activity. That has resulted in the rate of 11 per cent.³⁶

3.23 The hurdle rate of 14–15 per cent, in place from 1996 till 2002, however:

...was done on a slightly different basis. But both applied the capital asset pricing model that the ANAO recommends, in concept at least. But it was slightly different, in that it was more the interest rates at the time. We have now looked at a 10-year average, which we think is a better way to apply it for the future.³⁷

3.24 When asked to comment on this, given its criticism of the previous hurdle rate of 14–15 per cent, ANAO explained that it ‘would not quibble with the outcome’ of 11 per cent but it ‘would have a slightly different approach to calculating the rate’.³⁸ It had, however, quibbled with the calculation of the 15 per cent and the resultant outcome,³⁹ because the adoption of a hurdle rate of 15 per cent return for property overwhelmingly favoured the divestment of property over retention.

3.25 The Committee asked ANAO to provide an analysis of the sale of Commonwealth estate properties included in the three year divestment program reviewed by ANAO, by number and value for various hurdle rates. ANAO’s response is provided in Table 3.1.

3.26 Table 3.1 shows that between 1997–1998 and 1999–2000, nearly 38 per cent of the 58 properties sold fell within the hurdle rate band of 12–15 per cent or more. If the hurdle rate had been set at the current bandwidth of 11 per cent, then some 62 per cent of those same properties would *not* have been sold.⁴⁰ It would appear that the 1996 hurdle rate determining which Commonwealth properties were to be sold up till June 2002, did not take into account subsequent significant changes in interest rates and economic circumstances.

36 Bowen, *Transcript*, 31 May 2002, p. 43.

37 Bowen, *Transcript*, 31 May 2002, p. 44.

38 I. McPhee, ANAO, *Transcript*, 31 May 2002, p. 44.

39 McPhee, *Transcript*, 31 May 2002, p. 44.

40 Figure 2.2 in Audit Report No. 4, shows that the comparable percentages for 1996, were 31 per cent and 69 per cent respectively. ANAO, Audit Report No. 4, 2001–2002, p. 42.

Table 3.1 Commercial Office Estate Properties included in three year divestment program 1997–1998 to 1999–2000

Internal [Hurdle] Rate of Return ⁽¹⁾	Number of Properties	%	Value of Properties	%
Greater than 15%	6	10.3	\$13.85m	1.3
14-15%	9	15.5	\$258.75m	24.6
13-14%	7	12.1	\$59.45m	5.7
12-13%	13	22.4	\$393.8m	37.4
11-12%	9	15.5	\$38.22m	3.6
10-11%	6	10.3	\$55.68m	5.3
9-10%	4	6.9	\$207.5m	19.7
Less than 9%	4	6.9	\$24.65m	2.3
Total	58	–	\$1051.9m	–

(1) This table is derived from internal rates of return (IRR), used by the Commonwealth Property Committee in March 1997, that formed the basis of the properties selected in the divestment strategy. The IRRs were based on 30 June 1996 book values for the properties. These IRRs were determined prior to assessment of a market value for the properties and prior to implementation of leases based on commercial terms and conditions.

Source: ANAO, Submission no. 12, Attachment 1.

3.27 In response to comments about the hurdle rate, DOFA reiterated that the Government's view 'was that there is risk associated with holding property'—interest risks, facilities risks, rental risks, business changes and other post-September 11 risks. The Government believed that 'it was not necessarily in the business of owning property but in the business of using its resources in the best way to deliver services to the Australian people'. Therefore: 'The government adopted this hurdle rate. The sales program flows from that.'⁴¹

3.28 DOFA also pointed out that the initial hurdle rate was determined in the context of some uncertainty arising from a number of factors.

In 1996, when the Commonwealth property principles were being established, for the Commonwealth properties in question it was considered that there would be quite a large capital maintenance required on those

41 Bowen, *Transcript*, 31 May 2002, pp. 40–41.

properties in the coming years. There were no formal leases in place. There was no knowledge of adherence to local government regulations. They had been built by the Commonwealth on Commonwealth land, without reference to local and state government authorities.⁴²

- 3.29 Given these factors, DOFA advised the Government to adopt the higher hurdle rate to cover anticipated maintenance and other risks. Namely, instead of a risk factor of 0.5 per cent, it used a three per cent factor.⁴³ DOFA told ANAO that the CPC had considered that some of the assumptions underlying the modelling 'were overly optimistic and had the effect of unduly inflating the calculated rate of return figure'.⁴⁴ However, as ANAO emphasised in its report, the project specific risks for the properties were not high.

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.⁴⁵

- 3.30 As a result of the hurdle rate adopted, six in the list of divested buildings were sold even though their calculated value met the hurdle rate. The Committee was told by ANAO that these properties originally did not have a commercial lease and that the assumptions underpinning the rate of return calculations were changing as time went on.

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.⁴⁶

- 3.31 ANAO believes that DOFA failed to maintain an ongoing monitor of the sale process and to update advice to ministers as real data

42 K. Campbell, DOFA, *Transcript*, 31 May 2002, p. 45.

43 Bowen, *Transcript*, 31 May 2002, p. 46; ANAO, Audit Report No. 4, 2001–2002, p. 39.

44 ANAO, Audit Report No. 4, 2001–2002, p. 48.

45 ANAO, Audit Report No. 4, 2001–2002, p. 44.

46 ANAO, Audit Report No. 4, 2001–2002, p. 92.

emerged. Instead the 15% hurdle rate remained in place even though it was based on assumptions made in 1996 in a changing market.

- 3.32 The book values of the properties being divested were adjusted to take account of market conditions at the time and of 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. Despite this, rates of return for the properties were not recalculated based on these revised assessments. If they had been, the rates of return would have increased, thus generally supporting a higher retention of properties in Commonwealth ownership.⁴⁷

Sale management

- 3.33 A number of matters arising from the management of the sale were examined by ANAO.
- 3.34 Because a number of the occupants were Commonwealth agencies leasing Commonwealth funded properties, some of which were specific purpose built, these agencies paid a capital use charge but were responsible for repairs, maintenance and refurbishment.⁴⁸ In preparation for the divestment of the properties, CPC's proposal—that the occupant agencies pay a commercial rent to DOFA which would fund repairs, maintenance and refurbishment from the rent money—was adopted.⁴⁹
- 3.35 When the pro forma leases were subsequently developed by DOFA, these agencies found themselves responsible to the private sector landlords for both market rent as well as repair and maintenance costs.⁵⁰

47 ANAO, Audit Report No. 4, 2001–2002, p. 48.

48 ANAO, Audit Report No. 4, 2001–2002, p. 50.

49 ANAO, Audit Report No. 4, 2001–2002, p. 50.

50 ANAO, Audit Report No. 4, 2001–2002, p. 50.

- 3.36 Prior to the sale of the RG Casey building, DFAT as lessee, had a commitment to pay DOFA \$0.52 million annually in addition to rental and other charges under the lease as part of the provision of agreed capital works, reflecting amortisation of those costs over the original 15 year lease. On the sale of the RG Casey building, this clause remained in the executed lease, thereby providing the new owner an additional income stream from the property. ANAO stated that in the case of the Commonwealth, it 'is unaware of a general practice of agencies selling to the private sector a stream of transfer payments between Commonwealth agencies'.⁵¹
- 3.37 Similar arrangements occurred with the sale of the Commonwealth Offices in Bendigo, whereby an additional lease commitment of \$0.12 million per annum was included in the lease. This amount had resulted from the amortisation of the cost of the fitout of the premises—a cost incurred before any decision to sell. ANAO calculated that this additional amount represented about ten per cent of the market value of the property.⁵²
- 3.38 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. DOFA 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. Instead, DOFA 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.⁵³
- 3.39 ANAO discovered that during evaluation of tenders in April 2000, the sales adviser managing the sale, assessed the terminal value of the AGSO property to be \$15 million, which essentially equated the 20 year lease with 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.
- 3.40 ANAO believes the objective in a sale/leaseback property transaction is to negotiate a contract with the preferred bidder

51 ANAO, Audit Report No. 4, 2001–2002, p. 76.

52 ANAO, Audit Report No. 4, 2001–2002, p. 76.

53 ANAO, Audit Report No. 4, 2001–2002, pp. 83–84.

that delivers the highest possible positive Net Present Value (NPV) in order to ensure that the Commonwealth's financial position is maximised. 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.⁵⁴ DOFA calculations, in its advice to the Minister in April 2000, indicated a *positive* NPV of \$43 million.⁵⁵

- 3.41 In its report, 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.⁵⁶
- 3.42 At the public hearing, DOFA maintained that it did not accept the break-even methodology used in the audit. For instance, DOFA's own analysis showed that the internal rate of return for Discovery House was 9.73 per cent which was below the hurdle rate 'then and now and for 2003'.⁵⁷ DOFA told the Committee that its analysis 'would show that it was a value for money decision and that in fact it would still be a value for money decision based on a 10 per cent or a 9.5 per cent hurdle'.⁵⁸

Committee comments

- 3.43 While the Committee accepts that the differing views of the ANAO and DOFA as to the effectiveness of the properties sale are derived from differing policy perspectives on the matter, nevertheless,

54 ANAO, Audit Report No. 4, 2001–2002, p. 117.

55 ANAO, Audit Report No. 4, 2001–2002, pp. 114–117.

56 ANAO, Audit Report No. 4, 2001–2002, p. 106.

57 Campbell, *Transcript*, 31 May 2002, p. 43.

58 Bowen, *Transcript*, 31 May 2002, p. 43.

greater attention should have been paid to providing the Government with ongoing advice about the hurdle rate, especially as the economic factors were changing rapidly. In addition, DOFA should be considering the whole-of-life costs and benefits for each property to ensure that, in the total picture, the Commonwealth achieves best value for money and actions taken are in its best interests. To ensure that the Commonwealth's financial position is maximised, the objective in the sale/leaseback property transaction is to negotiate a contract with the preferred bidder that delivers the highest possible Net Present Value (NPV).⁵⁹

Risk transfer

3.44 The result is that the purchasers were able to revalue some properties post-sale and recoup some of the purchase price in their rental arrangements. ANAO found that 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.⁶⁰ The Australian Valuation Office noted in its valuation of 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.⁶¹ However, DOFA maintained to the Committee that 'the rentals set, in negotiation with the building tenants, reflected the prevailing market values for purpose buildings'.⁶²

3.45 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 \$22 723 537.⁶³ When questioned about this at the public hearing, DOFA was able to tell the Committee:

Whilst you are correct in saying that the new owner sought an increase of 38 per cent for RG Casey House,

59 ANAO, Audit Report No. 11, 2001–2002, p. 19.

60 ANAO, Audit Report No. 4, 2001–2002, p. 108.

61 ANAO, Audit Report No. 4, 2001–2002, p. 108.

62 DOFA, Submission no. 15, p. 2.

63 ANAO, Audit Report No. 4, 2001–2002, p. 110.

the end result was an increase—once it had gone through the appropriate negotiation clauses within the lease regarding rental increases—of \$6 per square metre. ...It is two per cent or thereabouts.⁶⁴

- 3.46 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 for Discovery House 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.⁶⁵
- 3.47 ANAO believed that its legal advice showed that a range of ownership risks with only some of the benefits had been transferred to AGSO, as the tenant, after the sale of AGSO Headquarters.⁶⁶ For instance, AGSO is responsible for, among other things:
- all operating expenses, including the landlord's insurance and landlord's management costs of the land and building;
 - all statutory charges;
 - replacement of all floor coverings in the building;
 - maintenance and painting of all surfaces, interior and exterior—including keeping the building watertight;
 - maintenance of the building and grounds under the landlord-approved general maintenance program; and
 - repairs and maintenance of plant in accordance with a landlord-approved program.⁶⁷
- 3.48 DOFA advised ANAO in April 2001 that both the sales adviser for the AGSO property sale and DOFA had always considered the lease to be an operating one and that additional professional advice was sought only after ANAO raised concerns. ANAO

64 Jackson, *Transcript*, 31 May 2002, pp. 42–43.

65 ANAO, Audit Report No. 4, 2001–2002, p. 111.

66 ANAO, Audit Report No. 4, 2001–2002, pp. 119–120.

67 ANAO, Audit Report No. 4, 2001–2002, pp. 119–120.

concurred with the DOFA position that it was an operating lease for financial statement purposes.⁶⁸ When asked to clarify the risks factor, DOFA informed the Committee that ‘a key aspect of an operating lease is that the bulk of the risks of ownership must rest with the owner rather than the tenant’.⁶⁹

- 3.49 DOFA assured the Committee that because tenants are required to pay rents from their agreed departmental budgets, ‘these budgets were adjusted to reflect the agreed rents at the time agencies originally entered into the agreements’.⁷⁰
- 3.50 Since 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. The rent AGSO negotiated with the sub-leasing tenants was some 29 per cent below market rates and some 41 per cent below that paid by AGSO under the Head-lease.⁷¹
- 3.51 ANAO’s calculations on the financial evaluation of the AGSO property sale concluded that beyond Year 11, the cumulative rental outlays for the property would outstrip the value to the Commonwealth of the sale proceeds and any earnings from their reinvestment.⁷² ANAO believes that 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.⁷³

Committee comments

- 3.52 After reviewing these arrangements, the Committee agrees with ANAO that the sale of the Commonwealth estate properties with long leases in place provided the purchasers with guaranteed cash flows at high yields over long periods. In most of the leaseback arrangements, the properties sold were purpose specific, relatively new and requiring little maintenance or upkeep during the lease periods.

68 ANAO, Audit Report No. 4, 2001–2002, pp. 19, 63–65.

69 DOFA, Submission no. 15, p. 2.

70 DOFA, Submission no. 15, p. 2.

71 ANAO, Audit Report No. 4, 2001–2002, pp. 113–114.

72 See Figure 5.3 in ANAO, Audit Report No. 4, 2001–2002, p. 116.

73 ANAO, Audit Report No. 4, 2001–2002, p. 121.

- 3.53 While it appears that the tenanting agencies had their budgets adjusted to reflect the initial agreed rents, nevertheless from a whole-of-government viewpoint, it seems that the Commonwealth is incurring additional costs.

Rejection of audit recommendations

- 3.54 ANAO stated in its audit report that its recommendations 'are only included where it is not clear that action has taken place and/or is being contemplated'.⁷⁴ Where agencies have taken action or are in the process of making changes, 'such action is usually noted in the report'.⁷⁵ Having examined the audit recommendations in the report, the Committee asked at the public hearing why DOFA had rejected them all without any clear explanation other than to say that DOFA considered 'the concepts that underpin the report are fundamentally flawed'.⁷⁶

- 3.55 DOFA responded:

It is quite noticeable in this case that Finance disagreed with each of the recommendations in the report. I would have to say in some cases that was a fine line. There were genuine differences in our views on the methodology that was applied in some parts of the report. On some of the recommendations I think Finance's disagreement was more a statement that it was already implementing the proposals put forward by Audit.

I think I have already said that there was a high level of dialogue and we will continue to have that with ANAO. On this particular audit, while it may not come through in the report, there was a high level of interaction between the officers of ANAO and Finance. Finance did provide a significant amount of written comment. However, where Finance could have done better was in providing a much more fulsome final response in a consolidated, comprehensive way to the section 19 report.⁷⁷

74 ANAO, Audit Report No. 4, 2001–2002, p. 21.

75 ANAO, Audit Report No. 4, 2001–2002, p. 21.

76 ANAO, Audit Report No. 4, 2001–2002, p. 21.

77 Bowen, *Transcript*, 31 May 2002, pp. 35–36.

- 3.56 The Committee notes that DOFA and ANAO have resolved their differences and that ‘there was a high level of interaction between the officers of ANAO and Finance’ during the audit.⁷⁸ The Committee has also noted DOFA’s comment that: ‘On some of the recommendations I think Finance’s disagreement was more a statement that it was already implementing the proposals put forward by Audit.’⁷⁹

Recommendation 1

- 3.57 **The Committee recommends that the Department of Finance and Administration report to the Committee on whether the substance of the Australian National Audit Office’s recommendations have been accepted and are being implemented. .**

Better practices

- 3.58 The Committee endorses the audit suggestion that sale management better practices identified in Audit Report No. 4 should be applied to future Commonwealth property sales, including the forthcoming major sales at CSIRO and in the Defence portfolio. For instance, good administrative practice for an agency disposing of Commonwealth property with a long-term leaseback arrangement could include:
- determining whether or not the property should be sold in accordance with the relevant policy;
⇒ and establishing the full market value for the property;
 - in determining the ‘full market value’, recognising whether there are special conditions attached to the property, and reflecting the fact that the property is sold with a secure Commonwealth lease-back arrangement, often for a lengthy period;
 - assessment of value for money during tender evaluation in sale and long-term leaseback transactions to the Commonwealth;
and

78 See *Transcript*, 31 May 2002, pp. 34–35.

79 Bowen, *Transcript*, 31 May 2002, p. 35.

- taking into consideration FMA Regulations 9 and 13, together with those inquiries required under the *Commonwealth Procurement Guidelines and Commonwealth Disposal Guidelines*.

Recommendation 2

- 3.59 **The Committee recommends that the Department of Finance and Administration, in consultation with the Australian National Audit Office, by June 2003, develop, publish and apply a sale management better practice guide for the disposal of future Commonwealth estate properties underpinned by the Commonwealth Property Principles.**