The Members of the Legislative Assembly
Parliament House
SYDNEY NSW 2000

In compliance with Section 38E of the *Public Finance and Audit Act 1983,* I present a report to the Legislative Assembly titled **Government Office Accommodation.**

A C HARRIS

Sydney
December 1997

Performance Audit Report

Government Office Accommodation

State Library of New South Wales cataloguing-in publication data

New South Wales. Audit Office.

Performance audit report : Government office accommodation / {Audit Office of New South Wales}

ISBN 0731315588

1. Executive departments - New South Wales - Buildings. 2. Public buildings - New South Wales - Planning - Auditing. 3. Office leases - New South Wales - Auditing. I. Title: Government office accommodation.

352.5609944

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Executive Summary

Executive Summary

The Audit

The Audit Office has undertaken an audit on *Government Office Accommodation.*

The audit examined the cost effectiveness of long-term leasing versus ownership and the housing of agencies involved with the delivery of core government activities. Core activities are those intrinsically linked to basic and ongoing functions of Government and Parliament.

Past accommodation arrangements have not resulted in an efficient and effective allocation of accommodation for all of the Government's activities. There is a greater need to consider Government ownership of offices for core and long-term government activities.

A Profile

Government agencies occupy about 1.14m square metres (sqm) of office space across New South Wales at an annual cost of $202.3m (in terms of rent and rent equivalent).

The Crown Property Portfolio (**CPP**), owned by Treasury and administered by State Property, consists of around 314,496 sqm (or 30% of the total Government office accommodation space of 1.14 m sqm).

Government office accommodation is divided equally between owned premises 50.1%, and leased premises 49.9%.

Government Office Accommodation Management Framework

Premier's Memorandum No 97-2 *Government Office Accommodation and Property Disposal* was promulgated as of 12 February 1997.

The Memorandum establishes a range of important principles and practices that will facilitate a coordinated, strategic and whole-of-Government approach to managing office accommodation and property. Under this revised policy, the Department of Public Works and Services (**DPWS**) is responsible for the centralised coordination across the public sector of leasing office accommodation and property disposal.

The introduction of a procedure to confirm compliance by agencies with the Memorandum is considered appropriate.

Ownership vs Leasing - Research

The question of ownership versus leasing can be complex.

Studies conducted around Australia and overseas indicate that, other things being equal, it is generally more cost-effective to own accommodation than to enter long-term leases.

However the availability of funds which may be used for the purchase or construction of office accommodation on the one hand or for the lease of accommodation on the other hand is subject to wider Government priorities and objectives.

The former Property Services Group (PSG) undertook a study in 1994 which concluded that long-term office accommodation needs should be met from a portfolio of owned buildings.

The PSG report also suggested that a financial analysis should be undertaken for each major accommodation decision and that it is advantageous to the Government to lease some accommodation, to provide maximum flexibility and to balance a portfolio of owned buildings.

This view is supported by The Audit Office.

Core Functions

It is not clear why core functions of the Government, such as Premier's Department, Treasury, Cabinet Office are housed on a short-term lease basis.

The Audit Office is of the view that there are strong and persuasive economic arguments for housing these activities in Government-owned offices.

Ownershipvs Leasing - Case Studies

In the three instances where long-term accommodation was procured by leasing arrangements, the net present value of lease payments indicates that it would have been more economical to accommodate those activities in Government-owned offices.

In each instance, the net present value of the rent over the life of the lease, would be near to, and in some cases would exceed the likely value of the building occupied. In other words, the net present value of lease payments would have been sufficient, or nearly sufficient, to build/purchase a similar building.

DPWS is reviewing the issue of ownership versus leasing as part of a strategic plan for government office accommodation which will be submitted for the consideration of Government in the near future. Also DPWS has engaged Coopers and Lybrand, Chartered Accountants to develop a financial model to be used for the analysis of ownership versus leasing scenarios.

Noel Park House

As part of the audit, and at the request of the Minister for Education, The Audit Office examined the lease arrangements, including its financial implications, of Noel Park House at Tamworth. The audit was incomplete due to advice from a representative of DPWS that some of the documentation relating to Noel Park House had been either lost or destroyed.

Noel Park House is a multi-occupancy building legally owned by the private sector and leased to the Government from 1992 for 25 years.

It is noted that the decision to commit to a long term lease was based on the view of the Technical Evaluation Panel that, given the then state of the finance and property markets, a 10 year lease term, as was originally sought by the Government, was not a viable option for investors in country regional centres.

The Department of School Education (DSE) was one of the original and major tenants of Noel Park House. The length of the lease entered into by DSE, 25 years, is much longer than that arranged for other tenant agencies. The reason for the disparity of lease terms cannot be determined from available documentation.

DPWS has advised that long term leasing arrangements (such as Noel Park House) would not now be contemplated by DPWS for longer than 10-12 years.

Given the length of the lease, the quantum of rent and the rate of interest implicit within the lease, it would have been more economical for the Government to have purchased the building than precommit to a long-term lease.

The Government has, and will have, no equity in the building now or at the expiration of the lease, but it bears all the risks and all costs associated with ownership.

Compared to the market conditions the Government is paying a higher rental than it should.

Given the substance of the lease transaction, in terms of the relevant accounting standard, the lease appears to be a finance lease. In this circumstance it is likely that the current accounting treatment for Noel Park House is not correct within the financial statements of the Crown Property Portfolio (CPP), where it is reflected as an operating lease.

DPWS has advised that future financial statements of the CPP will reflect the correct accounting treatment.

Asset Sales

The audit also reviewed the impact of proposed sales of Government owned office blocks on its long-term accommodation requirements. Expectations are that these sales will raise $364m in 1996-97, $500m in 1997-98 and $221m in 1998-99.

Recent sales of significance include the State Office Block, Pacific Power building (Hyde Park Tower) and the St James Centre.

The revenue generated from sales clearly provides an apparent budgetary benefit to the Government, but that benefit is often less than the long-term costs of the replacement leases.

Documents reviewed by The Audit Office suggest properties have been sold because of short-term budget imperatives, irrespective of the longer-term operational, strategic or economic considerations.

The sales option may ultimately be the more expensive than if the Government had retained office accommodation.

Leased Premises

The currency of the Government's leasing arrangements was also reviewed.

At the time the data analysis was undertaken for this report, 24.2% of total Government office leases had expired, yet the Government remained a tenant within these leased premises. A further 68% of all leases will expire by the end of the year 2000.

In total, 92% of the total number of all leases will have expired (but continue to be tenanted by Government agencies) or will expire by the end of the year 2000.

The annual cost to the Government of these leases is $159m of which over 39% ($62.4m) is in the Sydney CBD.

Although opinions differ, some market forecasters predict that rent levels in the CBD will double by the year 2005. This would, potentially, result in an annual rental increase in excess of $100m to the Government in the CBD alone assuming existing occupancy levels.

The figure of 24.2% above includes the CPP, that is government to government tenancy arrangements which are considered by DPWS to entail less risk to, for example, security of tenure than leases with private sector landlords. DPWS has advised that when CPP tenancies are removed from the statistic of 24.2%, the number of expired leases is 7.1%.

The extent of expired/expiring leases, whether with the private sector or on a government to government basis, does suggest a need for better portfolio management to ensure that tenants are aware of the lease terms and conditions which should be consistent with the market.

Within the CPP, DPWS is taking steps to address the issue of expired and expiring leases with the promotion of a user friendly tenancy agreement which is intended to encourage agencies to formalise agreements in a timely manner.

Management Information

The DPWS maintains a Government Office Accommodation Database which contains information on 133 government agencies.

The database is updated annually by an Office Accommodation Survey of all government agencies. Data relating to that portion of the CPP which is managed by a private sector contractor is periodically updated on advice as and when accommodation changes occur.

The majority of the data analysis contained in section *5: Office Accommodation: A Profile* has been sourced from the Database as at March 1997 and based largely on 1996 data survey returns.

Historically the database has not been reliable because:

- agencies were not obliged to return surveys
- agencies were not held accountable for the accuracy of information provided
- database definitions were not explained clearly or understood, causing uncertainty among agencies
- some information was updated irregularly.

The Audit Office conducted its own survey of selected agencies' key indicators of area occupied and rental payments. A comparison of the information supplied by these agencies with DPWS data showed a material variation. For example, the figure for total area occupied at one agency was over 61% lower than the database figure, while the amount of rent paid by that agency differed by 24% from the amount registered in the database.

These variations also cast doubt on the reliability of information for management purposes. This circumstance requires the DPWS to verify information extracted from the database prior to its dissemination to interested parties.

DPWS has addressed the issue of database definitions through the development and distribution of *The 1997 Survey - A Guide*. Other actions that have been undertaken to improve the completeness and accuracy of the database are identified in section *5.7 The Office Accommodation Database*

Vacancy Rate Monitoring

Vacancy rates - that is the amount of floor space available as a proportion of total floor space - are not reported by DPWS across the whole of Government. Mainly this is so because the information provided by agencies, via the annual Office Accommodation Survey and other sources, is considered by DPWS as not reliable.

Based on figures provided by DPWS to The Audit Office and sourced from the Government Real Estate Group (GREG) National Benchmarking Survey Report (October 1996) of which DPWS is a participant, the CPP at 3% has the highest vacancy rate when compared to the total portfolios of other States and Territories.

When adjusted for property considered by DPWS to be unlettable for operational or strategic reasons, the vacancy level for the CPP is 2.1%.

Recommendations

It is recommended that:

Ownership versus Leasing

- the Government consider owning office accommodation, as opposed to leasing, for its long-term core needs, subject to a case by case analysis of the relevant financial and non-financial factors
- the Government undertake an analysis of the costs/savings from proposed asset sales of office accommodation in light of the demonstrated need for long-term office accommodation (for core needs)

New, Expired and Expiring Leases

- given the findings of the own versus lease case studies presented in this report, it is recommended that the Government require agencies to undertake, in collaboration with the Department of Public Works and Services (DPWS), a cost/benefit analysis of available accommodation options prior to committing to any proposed *major* new leases
- the Government direct the DPWS, in collaboration with all agencies, to negotiate the renewal of all major *expired/expiring* leases (where continued occupancy is warranted) in order to reduce the financial risk of above-market rent increases and the risk of cancellation of leases

  (Major leases are defined, for the purposes of these recommendations, to be those over $500,000 rental per annum or a netlettable area over 1,000 square metres)

Management of Property Information

- in order to improve the integrity of the Government Office Accommodation Database, agencies be required to respond to the annual data request from DPWS by a predetermined date
- a senior officer within each agency be required to certify to the accuracy of information provided by an agency as input to the database maintained by DPWS
- DPWS verify, on a sample basis, information provided by agencies as input to the Government Office Accommodation Database

Premier's Memorandum No 97-2

- the compliance by agencies with Premier's Memorandum No 97-2 *Government Office Accommodation and Property Disposal* be established by DPWS.

Responses to the Report

The Department of Public Works and Services

I refer to your letter of 23 October 1997 forwarding a copy of the completed performance audit titled Government Office Accommodation.

The Department of Public Works and Services has reviewed the report and, in general, has found that the findings are consistent with the Government's accommodation reform initiatives. In this regard, Premier's Memorandum 97-2 has established a reform framework which will be further consolidated with the proposed Government Office Accommodation Strategies which will be submitted to Cabinet shortly.

In closing, I would like to acknowledge the Audit Office's co-operation and willingness to discuss aspects of the report and to accommodate my Department's comments and suggested changes.

Signed
Director-General
25 November 1997

New South Wales Treasury

I refer to your letter dated 23 October 1997 seeking Treasury's comments on a performance audit report titled Government Office Accommodation. This report has, as I understand, now been presented as a result of discussions held between your office and representatives from the Department of Public Works and Services (DPWS).

Many of the issues raised in the audit report are in part being addressed in various government initiatives aimed at improving the performance on a whole of government office accommodation perspective and have in part been canvassed in the Arthur Andersen (AA) report.

As you are aware AA were engaged to review the management of the Crown Property Portfolio and from their own analysis of other government and private sector corporate accommodation management practices there was an indication of a strong trend away from direct ownership of property for office accommodation. It has therefore been recommended that where the market is capable of providing a supply of adequate standard accommodation, securing accommodation under leased arrangement should be the preferred strategy.

However, Treasury agrees that decisions between owned and leased accommodation should be subject to ownership demonstrating a lower net present value of costs compared to lease options. In this regard DPWS has also commissioned Coopers & Lybrand to develop a financial model to be used by agencies for the analysis of ownership versus leasing scenarios.

There are of course exceptions to the rules and in particular the government has a number of properties which are heritage listed and these need special consideration depending on the policy imperatives of the Government.

As to the issue of leases, given the volatility of property cycles it may be possible for owners and renters to end up on the 'wrong' side of leases. This says more about their lack of knowledge of contract strategy than ownership versus leasing. It is as a result of this volatility in the property market that it may be possible to enter into agreements at the rising or top of the market and have revenue/rental streams which do not fully take into account the cycle itself.

In order to address these issues further the Government is in the process of implementing initiatives aimed at improving the performance on a whole of government office accommodation perspective. The recent release of a Premier's Memorandum No. 97-2 Government Office Accommodation and Property Disposal and the current development of a Government Office Accommodation Strategic Plan and Future Directions paper by DPWS are testimony to this Government's work in the area.

In addition, discussions are also underway with the DPWS for the establishment of a Government taskforce, which will also include Treasury involvement, whose primary objective will be to recommend to Government an overall policy framework for government property management, together with implementation arrangements.

I would like to thank you for providing the opportunity to make comments on the report.

Signed
Secretary
14 November 1997

1 Introduction

1.1 The Government's Office Accommodation Management Framework

Office accommodation represents a major recurrent cost to the public sector, second only to that of salaries and wages. The proper management of this portfolio is therefore essential to the Government's objective of providing efficient and effective service delivery.

Government policy in regard to office accommodation is described in Premier's Memoranda and supporting documentation.

Premier's Memorandum No. 92-7 *Government Office Accommodation*

Premier's Memorandum No. 92-7 *Government Office Accommodation* (19 March 1992) indicated the then Government's desire to minimise the cost of office accommodation and to maximise the use of buildings which it owned or leased.

To achieve this outcome, and from that date onwards, no budget dependent agency was to enter into a lease for, or occupation of new office space, or to change its existing lease arrangements, without coordinating the changes through the then Property Services Group (PSG).

Premier's Memorandum No 97 -2 *Government Office Accommodation and Property Disposal*

In September 1996 the Government commenced a reform of the management of Government office accommodation when Cabinet agreed to a number of new procedures and strategies. Premier's Memorandum No. 97-2 *Government Office Accommodation and Property Disposal* (12 February 1997) gave effect to Cabinet's decisions.

Under this revised policy, DPWS is responsible for the centralised coordination across the public sector of leasing office accommodation and property disposal.

Under this Memorandum, new benchmarks and procedures for managing office accommodation were established including:

- a target of 18 sqm per person as an average whole-of-agency figure
- requirements for mandatory facility planning for accommodation changes over 500 sqm
- a coordinated across-Government approach for leasing accommodation to ensure that existing vacant space is occupied where possible, and
- a whole-of-Government approach to the disposal of large and/or strategic property assets.

One of the outcomes of this spatial reduction strategy referred to above will be to rationalise agencies into high efficiency owned space and dispose of/move out of low efficiency space. Reducing the Government's exposure to increasing office accommodation costs over the next decade is also an objective.

Integral to the implementation of this new policy is the development by DPWS of an Accommodation Masterplan.

This Masterplan, now being prepared by DPWS and retitled the *Government Office Accommodation - Strategic Plan and Future Directions*, is aimed at identifying the principles and actions to further lift performance and improve the management of office accommodation. This Strategic Plan is expected to be submitted to Cabinet in the near future.

The arrangements within the Memorandum and Strategic Plan are intended to achieve the Government's objective of best practice in terms of office accommodation.

1.2 Roles and Responsibilities

DPWS

According to DPWS:

> *The NSW Government requires sound, specialised property services to maximise returns on its vast portfolio of property assets. This involves long range strategic accommodation planning at the regional and agency level, implementation of decentralist initiatives, infrastructure and property development, strategic procurement and disposal of assets, facility management, portfolio asset management and lease negotiation skills*[1].

Following the issue of Premier's Memorandum *97-2 Government Office Accommodation and Property Disposal*, DPWS's responsibilities in relation to office accommodation were amended to include the following:

- assistance to agencies in the preparation of their Office Accommodation Plans
- development of an overall Management Strategy for office accommodation. That is, a *Masterplan* incorporating key performance benchmarks and criteria, an accommodation strategy, statewide regional plans and an asset plan for the CPP

[1] DPWS, *In Partnership*, Vol 1 No 1 November 1996, p7.

- preparation of office accommodation Space Standards to assist agencies in the planning of their office space requirements
- maintenance of the *Government Accommodation Planning Database.*

State Property

State Property, a branch of the Commercial Business Division of DPWS, is staffed with a specialist group of individuals with a broad range of government and commercial experience in operational and strategic property management. The branch is responsible for the management of whole-of-Government office accommodation needs and requirements. State Property is also responsible for the administration of the CPP which is discussed in more detail under *1.3 Crown Property Portfolio.*

Policy Division

As of December 1996, the Policy Division of DPWS has acted in an advisory capacity on such issues as the purchase and disposal of assets, maintenance and other supporting infrastructure requirements, estimating accommodation demand etc. The division is also responsible for whole of government accommodation policy and strategic planning.

Treasury

Treasury has fulfilled the “landlord” role with respect to the CPP since the early 1990s, and entered into a five year Management Agreement with the former PSG (now part of DPWS) to manage the CPP portfolio as from November 1993.

The Management Agreement imposes certain reporting requirements on State Property, including the preparation of:

- monthly management reports
- quarterly accounts
- annual financial statements.

In consultation with DPWS, Treasury commissioned Arthur Anderson (December 1996) to undertake an independent review of the management arrangements between Treasury and State Property with respect to the CPP.

A report by Arthur Anderson has been provided to Treasury officials.

1.3 Crown Property Portfolio

Crown Property Portfolio (CPP)

The CPP, owned by Treasury and administered by State Property, consists of around 314,496 sqm (or 30% of the total Government office accommodation space of 1.14 m sqm).

The creation of the CPP followed a recommendation of the NSW Commission of Audit Report (1988). Records of what the Government owned and leased were regarded as incomplete by the Commission.

The CPP comprises all multi-tenanted owned buildings and all head-leases where there is more than one government agency in occupation, and a diverse range of properties which are surplus to government requirements and are being held for strategic purposes such as the Chief Secretary’s building or are in preparation for disposal.

It is divided into portfolios comprising owned properties, leased properties, and other properties not primarily associated with accommodation including land, industrial estates, heritage properties and other specialised uses.

Most CPP properties are located in the country (63%), while in terms of area, the majority of space is located in the Sydney CBD (53%).

State Property administer the CPP on behalf of Treasury. The responsibility for the day-to-day management of the owned and leased office accommodation portion of the CPP has been outsourced to a private sector property manager.

1.4 Cost of the Audit

Direct salaries costs	$236,518
Printing (estimated cost)	$ 6,000
Total	**$242,518**

The cost of examining the lease of Noel Park House, Tamworth at the request of the Minister for Education is $20,261. This cost is included in the above figure of $242,518.

1.5 Acknowledgment

The Audit Office wishes to acknowledge the assistance provided to the audit team by representatives of the Department of Public Works and Services, Treasury, and the Department of School Education.

2 Ownership versus Leasing

Overview

The issue of ownership versus leasing can be complex.

Apart from a financial analysis of lease versus own, resolution may be influenced by other factors such as the Government's objectives for decentralisation or economic development, or strategic planning by an agency as a result of client service needs.

Most research conducted on the issue of office accommodation concludes that for the Government's longer-term requirements, it is generally more cost effective to own than lease office accommodation.

This conclusion is qualified to the extent that no general answer is applicable in all cases. A financial analysis, together with consideration of all other relevant factors, should be undertaken for each major accommodation decision.

2.1 Owned vs Leased Office Accommodation

The 1.14m square metres (sqm) of office accommodation space under the control of agencies is divided equally (in terms of area) between *leased* and *owned*:

49.9% Leased	50.1% Owned

A comparison with the own vs leased situation in the other States/Territories reveals the following:

Other States & Territories

Figure 2.1: Owned v Leased Office Accommodation

Source:

1. DPWS Government Office Accommodation Database
2. The Government Real Estate Managers Group, *National Benchmarking Survey Report*, October 1996

Crown Property Portfolio

Within the CPP (around 30% of the total office accommodation), the proportion is weighted towards leasing, with around 66% of the CPP's space requirements being leased office accommodation and 33% owned.

2.2 Relative Benefits/Cost of Leasing

Advantages of Leasing

In general commercial terms, leasing provides several advantages over ownership, some of which include:

- the maintenance of capital and credit lines and enhanced control of cashflows
- taxation advantages
- removal of the risks associated with ownership including: poor asset performance, obsolescence, space limitations of current building, loss on disposal, etc
- flexibility of office space provision where supply is adequate
- considerable purchasing power for lessees of large areas subject to timing and market conditions.

Disadvantages of Leasing

The main disadvantages attributed to leasing are considered to include:

- exposure to market rent fluctuations
- the lost opportunity for capital gain through ownership
- loss of control over accommodation requirements
- not being able to tailor accommodation to the specific needs of each agency
- higher accommodation costs flowing from high-cost, private sector financing arrangements, subject to timing factors and market fluctuations
- higher accommodation costs flowing from short-term leases for long-term functions, subject to timing factors and market fluctuations.

The Advantages of Diversification

Ownership of a portfolio of office buildings of different sizes, ages and locations also spreads the risks of ownership of individual buildings over the total asset base.

2.3 Research on Ownership vs Leasing

Using a case study of eight properties, the former Property Services Group (PSG) examined whether it is preferable to own or lease office accommodation.

The financial results of these eight case studies are indicated overleaf as are the interpretation of the results.

Table 2.1: Summary of PSG Case Study Results			
Building **(1)**	**"Savings from Ownership" $'000s** **(2)**	**"Break Even" Discount Rate %** **(3)**	**Years to Break Even** **(4)**
Honeysuckle Office Development	1,559	8.7	> 20
McKell Building: sale/leaseback	30,821	19.6	14
State Office Block	1,912	7.4	> 20
Goodsell Building	3,108	8.0	> 20
Bligh House	702	7.4	> 20
GOB, Bathurst	705	10.4	13
GOB, Wollongong	6,235	11.0	17
GOB, Broken Hill	540	13.1	13

Source: Property Services Group, *An Examination of the Factors Pertinent to the Decision to Own or Lease Government Office Accommodation*, September 1994.

Interpretation of Results

In Table 2.1, *"Savings from Ownership"* refers to the Net Present Value (NPV) of taxpayer monies saved through owning rather than leasing over an assumed 20 year holding period.

These calculations utilise the standard (and Treasury sanctioned) discount rate of 7%, as assumed in Discounted Cash Flow (DCF) analysis. The "Break Even" discount rate (column 3) shows the discount rate at which the *financial* benefits of owning vs leasing have equal net present values (NPVs).

Column (4) indicates the number of years it would take for the cumulative NPV outflows for leasing and owning to be equal. That is, the large up front costs associated with owning can be justified (in a financial modelling sense at least) if long-term ownership is contemplated, because the higher recurrent costs of leasing eventually tip the balance in favour of ownership.

The usefulness of the DCF model as a decision tool ultimately depends on the quality of the data gathered and assumptions made by the user for any particular lease vs own analysis and the realities of the market.

For example, in some country areas no suitable stock may be available making construction, either by the Government or by a private developer through a pre-commitment to lease agreement, the only viable option.

State Property View on Own vs Lease (*in relation to the CPP*)

State Property documentation notes that the recent experience of several years of low rentals, due to an unprecedented oversupply in the CBD market and a recession-induced downturn in commercial activity, has led to a perception that office accommodation needs can most economically be met through leasing.

Because the market conditions are improving (see section *5 Office Accommodation: A Profile*), it is suggested in State Property advice to Treasury of May and July 1996, in its capacity as portfolio manager, that there is evidence that this view may have changed:

> *There is a basis for a strong argument that a balanced portfolio of owned and leased premises is the optimum solution in Sydney CBD and that the present mix* [within the CPP] *of 2.5:1 (leased to owned) is inappropriate.*[2]

DPWS Comment

In response to the above quote, DPWS has advised that the appropriate portfolio mix should be influenced by the state of the property and finance markets.

Principles to Own vs Lease

The *CPP Annual Portfolio Plan: Strategic Plan Report* (July 1996) prepared by State Property outlined four principles in ensuring a prudent *balance* of owned and leased premises will be held in the future.

Principle 1

Where market rental conditions are prone to periods of volatility, there should be a bias towards ownership (to minimise exposure to the volatility of the rental market and experience with being "locked in" to ratchet rent reviews during the down swings of the market).

Practice

The *CPP Annual Portfolio Plan Executive Summary* (July 1996) noted that over the last 18 months a significant shift had occurred in the balance between owned and leased accommodation, with two-thirds of the portfolio's space now leased.

> *... If this trend continues, along with the likely future growth in rentals, the Government could be exposed to cash flows unusually higher than previously.*[3]

The continued net disposal of owned properties suggests non-compliance with this principle.

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[2] *CPP Annual Portfolio Plan: Strategic Plan Report*, July 1996, p 7.
[3] *CPP Annual Portfolio Plan Executive Summary* (July 1996), p5.

DPWS Comments DPWS takes the view that the Government's office accommodation space requirements should be provided at the lowest cost option having regard to location requirements, suitability, service delivery needs of agencies and market cycle conditions at the particular time the need arises.

Furthermore, within the CPP, owned property assets used for operational purposes are now subjected to an annual review to confirm the achievement of the lowest cost option.

Principle 2

The standard of buildings to be constructed should not be too much higher than the future general market. Also government buildings should not be constructed in prime real estate areas (otherwise pressures can be created … ***to sell before the building has been fully amortised eg the State Office Block and potentially the Goodsell building***[4]**).**

Practice Currently no government office buildings within the CPP are under construction. Planning is now occurring in Parramatta and Central Railway sites for the Government's overall future accommodation needs.

Principle 3

Where there is a continuing large operational requirement in owned premises, they should not be sold. Decisions to sell buildings with a long-term leaseback can rarely if ever be justified on the basis of Portfolio improvement (that is proceeds from sale are not usually reinvested within the portfolio).

Practice The recent sale and leaseback deals entered into for the CBD-based Pacific Power Building and the sale of the St James Centre suggest this principle is not in force.

Principle 4

Unless there is an immediate or foreseeable operational requirement for an owned building it should be sold in the first optimum market conditions.

Practice According to reports, the sale of the McKell building in 1991 and more importantly the unfavourable timing of this sale in terms of the property cycle, would again suggest non-compliance with this principle.

4 *CPP Annual Portfolio Plan: Strategic Plan Report*, July 1996, p 20.

2.4 Other Views

A range of views on the issue of ownership versus lease is included within Appendix 6.*2 Research on the Question of Ownership versus Leasing*.

Government and Infrastructure Provision

Apart from these research analyses, in recent years there has been a move away from the traditional reliance on public sector owned infrastructure to support the service delivery objectives of Governments.

That is, Governments have tended to reassess their traditional role in asset creation and management because of a need to:

- apply limited resources to core functions
- allow for greater flexibility and adaptability in the roles and structures of government agencies
- take advantage of the increased sophistication and maturity in both the property and financial markets[5]

These arguments reflect a view that the Government should devote the available but limited resources to the achievement of its primary function, the delivery of services to the public. Because owning office buildings is not considered to be part of an agency or Government's core activities, limited resources should not be tied up in owning capital assets. The overall conclusion to be drawn from this approach is that individual agencies should lease their office space requirements and not own.

Locational Argument

Another view is that the primary consideration for Governments is the determination of the appropriate *location* of government agencies/services and the associated impact on the costs, efficiency and effectiveness of service delivery. According to this view, the question of own or lease is of secondary importance.

Property Cycle View of Ownership vs Leasing

Another view is that it is best to *own* when rents are increasing/vacancies are tight and the market is buoyant (but also sell when the market is peaking) and *lease* when the opposite market conditions prevail.

The first two views suggest that while leasing is affordable, owning offices is not. Leasing obligations do consume available resources and should be replaced by ownership where that is more efficient. The last view would require the Government to be a trader/speculator in office accommodation.

[5] Australian Procurement and Construction Council, 10/2/97.

3 Case Studies

Overview

This section of the report examines three long-term leases entered into by various administrations over the last 20 years.

The economic substance of each case study shows that the Government will have paid, effectively, for the cost of land and cost of construction of the building over the life of the lease.

In addition, in the first two case studies, that is Noel Park House Tamworth and John Maddison Tower Sydney, the Government bears the risks and costs associated with ownership.

For all three case studies reviewed, the decision to lease rather than own represents relatively poor economy for the Government.

This finding is consistent with the surveyed literature on the merits of ownership versus leasing as noted in section 2.3 and Appendix 6.2 of this report.

DPWS has commented that the analysis contained in this section of the report confirms its view that long term structured finance leases result in a higher cost than the ownership of assets.

Case Study 1:
Noel Park House, Tamworth

Background

The Minister for Education and Training requested the Auditor-General to review the Government's lease of Noel Park House, Tamworth in the following terms:

- why the lease was entered into for such a *long period of time*
- whether the cost of the lease was a *sound financial* decision
- whether NSW taxpayers received good v*alue for money* from the agreement, and
- whether there are any *policies or procedures* as a result of this agreement which need to be reviewed.

Noel Park House

Noel Park House (Tamworth) is a multi-occupancy building, constructed over the period 1990 to 1992 by Pluim Constructions Pty Ltd (hereafter referred to as Pluims). Pluims is the legal owner of the building.

Following a formal tendering process, Noel Park House was purpose built to the specification of the former PSG on behalf of the occupying departments, with terms and conditions agreed with Pluims including a 25 year lease arrangement.

At the time of initial occupancy (June 1992), the Department of School Education (DSE) and the Roads and Traffic Authority (RTA) were the major tenants, occupying 42% and 38% of the rented space, respectively. The building served as the then Regional Office for the DSE.

As a result of a subsequent restructuring of DSE in 1995-96, the Department required only around one-third of its original floor space. Other agencies, as tenants, have absorbed progressively the resultant vacant space caused by the changed circumstances of DSE.

Documentation

File documentation for Noel Park House was held by the Department of School Education (DSE) and DPWS as the latter absorbed the Property Services Group (PSG). Most file documentation was sourced from the DSE.

Audit Observations

DPWS was not able to provide certain key information to The Audit Office relevant to the review of Noel Park House. A representative of DPWS advised The Audit Office that:

> *Whilst a number of files make reference to certain aspects of the project, it would appear that a complete and detailed history of events is not available. The project was managed by the (former) PSG which was disbanded over 12 months ago, and it appears that many files were either lost or destroyed.*

Examples of information not able to be obtained during the course of the review were:

- the report of the feasibility study on the proposal to establish a multi-occupancy Government Office Block in Tamworth
- a complete copy of the tender evaluation report(s) prepared by the Technical Evaluation Panel on the 1990 Expressions of Interest/tender processes
- the reason(s) for DSE entering into a 25 year *sub-lease* to PSG
- reasons for the variation by the successful developer of the proposed rental review tender clauses (to the Government's disadvantage)
- any detailed Net Present Value analysis conducted as part of the tender evaluation process (final results only available)
- a copy of accommodation policies/procedures relevant at the time the pre-commitment to lease was made.

It is a requirement of the Archives Authority of NSW[6] for government agencies to retain files on matters relating to leasing for at least 7 years after the expiry of the lease, and for tendering processes, 10 years.

[6] The Archives Authority of New South Wales, *General Records Disposal Schedule: Administrative Records*.

The fact that many of the files required for this current investigation have reportedly been lost of destroyed would suggest that file management procedures need to be improved.

DPWS Comment

DPWS have advised that, whilst the Noel Park transaction was negotiated by PSG prior to it being absorbed within DPWS, DPWS will review its file management procedures to ensure that information relating to leases will now be retained for at least 7 years and for tendering for at least 10 years.

The Economy of the Transaction

Length of the Lease

The former Coalition Government gave a pre-commitment to lease Noel Park House from Pluims, as owners, for a 25 year lease to the Government, with the term being from 1992 to 2017.

This decision was based on the view of the Technical Evaluation Panel that, given the then state of the finance and property markets, a 10 year lease term, as was originally sought by the Government, was not a viable option for investors in country regional centres (unless the rental rate was to be set at a level significantly above market rates).

In any event, the rental rate of $259.50/sqm agreed with Pluims was around 25-30% above the then market rates (as determined by the Valuer-General's Office), with an annual increase in rent linked to movements in the CPI. Rent at the time of the audit was $278.37/sqm, compared to market office rentals in Tamworth of around $140/sqm to $180/ sqm.

Audit Observations

For reasons not known, DSE's sub-lease term of 25 years with PSG (Head Lessor) is much longer than the terms agreed to by the other government agencies occupying the building.

Compared to current market conditions, the Government is paying more than it should in terms of both the negotiated rent rate per square metre and the terms of the rental review mechanism embodied in the lease. These terms are contrary also to advice provided earlier by the Valuer-General's Office.

DPWS Comment

DPWS have noted that long term leasing arrangements (such as Noel Park House) would not now be contemplated by DPWS for longer than 10-12 years.

Value for Money

The Audit Office examined whether Noel Park House represented value for money. In particular, The Audit Office considered:

- whether it would have been more economical for the Government to have purchased the building as an alternative to leasing
- how the risks and benefits incidental to ownership of the building have been assigned. In this regard, reliance was placed on the economic/accounting framework embodied within *Australian Accounting Standard AAS17 "Accounting For Leases"*.

The Audit Office has calculated, for a range of discount rates and over various lease terms, the present value of lease payments. The results are shown below.

Table 3.1 Net Present Value of Lease Payments, Noel Park House Lease

Discount Rate	Implicit	T Corp	13.5%	Implicit	T Corp	13.5%	Implicit	T Corp	13.5%
Lease Term (years)	25	25	25	35	35	35	45	45	45
Cost ($m)	12.65	12.65	12.65	12.65	12.65	12.65	12.65	12.65	12.65
Discount Rates (%)	12.99	11.43	13.50	13.26	11.43	13.50	13.41	11.43	13.50
NPV Rentals ($m)	11.91	13.60	11.43	12.46	14.99	12.19	12.63	15.71	12.51
NPV/Cost	**94%**	**108%**	**90%**	**99%**	**118%**	**96%**	**100%**	**124%**	**99%**

Notes:

- Table 3.1 shows that, at the implicit rate in the lease (being the approach recommended in AAS17), the present value of lease payments are between 94% and 100% of the value of the building.
- If alternative discount rates are used (such as the then prevailing NSW Treasury Corporation 10 year rate), then the present value exceeds 100% of the fair value of the building.

Conclusion

The economic substance of this transaction is that the Government effectively pays for the cost of land and cost of construction over the life of the lease. In addition, the Government appears to bear a majority of risks incident to ownership of the property. To this extent, this is a similar outcome to that if the Government had purchased the building on its own site. But ownership of the building does not revert to the Government at the end of the lease term. Neither does the Government benefit from any increases in the value of the property.

On these measures the decision to lease (rather than own) Noel Park House does not represent value for money for the Government.

Funding

A structural and economic analysis report prepared for DSE by T.W. Crow & Associates in early 1990 concluded that of the options considered for office accommodation within Tamworth, the most favourable was that whereby the Government would develop and own the building it would occupy. However, Treasury advice of 1990, noting limited capital works funding being available, suggested leasing to be the only option at the time.

Audit Observations

From an economic point of view the availability (or otherwise) of funding is not a rational basis for assessing the merits of a lease versus construct/own decision.

An objective approach would be to adopt the option which delivers the highest net economic benefit to the Government.

Accounting Treatment

The present accounting treatment of Noel Park House is on the basis that its relationship with the private (legal) owners of the building is an operating lease (and hence off the State’s balance sheet).

This treatment relies on the view that a majority of the risks and benefits incidental to ownership of the building rest with its owners, Pluims, rather than the Government.

Audit Observations

This report does not conclude on the most appropriate accounting classification for the transaction. A more comprehensive deliberation on the appropriateness of the accounting treatment for certain transactions is to be addressed by The Audit Office, in a forthcoming report to Parliament, as part of an overall review of structured finance transactions of the State. It is anticipated that the report will review the accounting treatment for the State Bank building (Martin Place) and McKell building.

That said, the classification of Noel Park House as an operating lease does not appear to be adequately supported by the substance of the arrangement between the Government and the private owners for the reasons that:

- the lease is effectively non-cancellable.
- a majority of risks incident to ownership of the building are being borne by the Government.
- the present value of minimum lease payments over the lease term represents at least ninety percent of the fair value of the leased property, at the inception of the lease.

Response to Case Study 1

Department of School Education

The circumstances surrounding the Crown's lease of Noel Park House are noted. The Department has nothing to add in this regard.

In regard to the reference to the "accounting treatment" it is assumed that this refers to the Department of Public Works and Services. The Department of School Education is a tenant of the building and the lease is therefore reflected as an operating lease within the Department's accounts.

The Minister has been provided with a briefing and will issue a formal response in due course.

Director of Properties
21 November 1997

Audit Office Comment

In its response the Department has raised the issue of accounting treatment of the lease transaction.

As indicated within Case Study 1 the issue of the accounting treatment is to be addressed by The Audit Office in a forthcoming report to Parliament. It is noted however that the former Property Services Group is the Head Lessor of the building and that the lease of the Department is recorded appropriately as an operating lease within its financial statements.

Case Study 2:
John Maddison Tower, Sydney CBD

Background

John Maddison Tower (JMT) is located in Liverpool Street, Sydney. The twenty one level building was constructed during 1994/95 by Multiplex Constructions Pty Ltd, on behalf of the legal owners Downing Tower A Pty Ltd and Downing Tower B Pty Ltd (ALLCO).

The land on which the building is sited is owned by the Attorney General's Department which was represented in negotiations by the then Department of Courts Administration (DoCA).

The original objectives of the JMT project were to unite court and office accommodation for the civil jurisdictions of the District Court, the Compensation Court and the Land and Environment Court within one centre. Currently, the building is occupied solely by the Attorney General's Department with the Land and Environment Court relocating to separate premises in 1995.

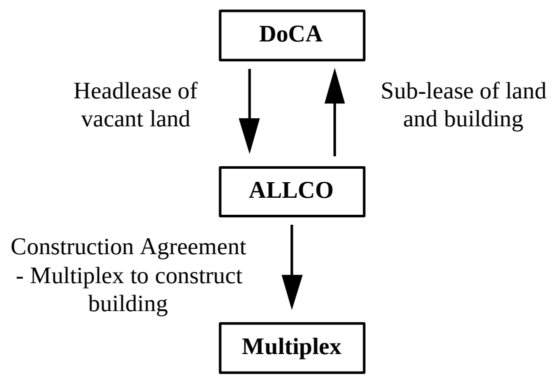
DPWS comment

DPWS have advised of no involvement with this financial transaction, noting that the former DoCA was responsible for this office development.

Leasing Arrangements

The leasing arrangements involved a headlease for the vacant land between DoCA (lessor) and ALLCO (lessee) and a sub-lease for both the land and building, upon construction of the building, again between the two parties with ALLCO as lessor and DoCA as lessee.

Figure 3.2 Leasing Arrangements



The Economy of the Transaction

Length of the Leases

The headlease for the vacant land is for a term of 42 years and 3 months. The sub-lease for the land and building is for a term of 25 years, having commenced upon completion of construction.

At the expiration of the sub-lease, DoCA has the option to renew the sub-lease for a further period of 15 years or to acquire, at market value, ALLCO's interest in the headlease.

At the final termination of the lease, the JMT building is to be demolished and the use of the cleared land returned to the Attorney General's Department. The cost of this demolition, effectively equivalent to five years land rent, is to be met by DoCA.

DPWS Comment

DPWS have noted that the clause providing for the demolition of the JMT building at the termination of the lease to be most unusual from a commercial point of view.

Value for Money

In approving the JMT project on 24 March 1993, the then Treasurer and Premier, noted in writing to the Minister for Justice and Emergency Services, that :

> *On the basis of the information provided that the project will achieve rental savings relative to current leases, <u>achieves a savings relative to a direct construction project</u> and <u>conforms</u> both technically and in substance with the conditions for an <u>operating lease</u>, approval is given to proceed with the project* [emphasis added]

For reasons noted overleaf, the evidence suggests these conditions were not met.

Audit Office Review

In 1996 The Audit Office conducted an audit of the JMT transaction for the purpose of forming an opinion on its accounting treatment. This included an examination of the economic substance of the sub-lease as well as how the risks and benefits incidental to ownership of the building were assigned as per *Australian Accounting Standard AAS17 "Accounting For Leases"*.

A discounted cashflow analysis of the lease transaction was also undertaken as part of the audit.

Conclusion

It would appear that the JMT project, as executed, represents an unfavourable economic decision for the Government. This conclusion is drawn from the following findings of that audit:

- the NPV of lease payments associated with JMT *exceeds* project costs. Even adopting discount rates used by the Government in evaluating the JMT proposal (these range from 7% to 7.964%) confirms this conclusion. Using the TCorp benchmark rate of 7.82% nominal (as at 30 June 1993, being the date the transaction was executed), being an alternative and objective measure, resulted in a NPV of cash flows equal to 129.6% of project costs (or 29.6% above cost)
- at the termination of the lease the building is to be demolished at the expense ofDoCA
- in terms of the net present value of the lease payments to be made by DoCA, it would appear that the Government is effectively paying for the cost of the building over the life of the sub-lease
- the majority of risks incidental to ownership of the JMT are borne by the Government.

Accounting Treatment

The JMT transaction was initially disclosed as an *operating* lease in the 1993-94 financial statements of the Department of Courts Administration (later merged with the Attorney-General’s Department). This treatment was the subject of an audit qualification at the time.

A revised (and correct) accounting treatment was adopted for subsequent years (1994-95 onwards), which reflected the transaction as a *finance* lease. This resulted in a liability of $51.96m and a corresponding asset being brought to account.

The Audit Office has concurred with the amended accounting treatment because it more appropriately reflects the assessment that the majority of risks and benefits incidental to ownership of the building actually rest with DoCA. In addition, it fulfils other guidance contained in *Australian Accounting Standard AAS17 “Accounting for Leases”* that indicate that the transaction is a finance lease, viz:

- the sub-lease is effectively non-cancellable
- the sub-lease is effectively for a term of greater than 75% of the useful life of the building

- the present value of the minimum lease payments over the lease term represent greater than 90% of the fair value of the building.

The broad parameters adopted by The Audit Office in coming to that conclusion included:

i. a nominal discount rate of 10.565% (determined by calculating a NPV of the lease payments equal to the fair value of the property in question at the commencement of the lease)

ii. minimum lease payments of $4.057m p.a., escalated by CPI over a period of 25 years (the length of the sub-lease)

iii. fair value for the project's costs of $51,962,930 at the commencement of the lease.

The Audit Office's conclusion was supported by a sensitivity analysis of the results using a range of alternative discount rates, viz:

- 7.964% as per the tender documents submitted by ALLCO in March 1992
- 7% as per the Economic Appraisal undertaken by Nicholas Clark and Associates in October 1993
- Commonwealth Treasury ten year bond rate of 7.66% as at 30 June 1993
- TCorp benchmark rate plus 10 basis points of 7.82% as at 30 June 1993.

Response to Case Study 2

The Attorney General's Department

I refer to your letter of 23 October regarding the Performance Audit Report titled Government Office Accommodation. The overall recommendations given in the Executive Summary are supported. I agree that accommodation decisions should be subject to a case by case analysis and that the Department of Public Works and Services should be consulted in carrying cost/benefit analyses for any proposed major new leases.

In relation to Case Study 2 on the John Maddison Tower, while I share most of your concerns with the lease arrangement, the analysis appears to underestimate some of the positive aspects of the project. In particular, the construction risk was eliminated for Government and the building was completed on time, within budget and with minimal variations. A comparison of similar construction projects controlled by Government would have enhanced the analysis.

The Case Study also points out that the NPV of lease payments exceeds project costs by 129% using the Tcorp benchmark rate of 7.82% nominal. However, using the Treasury recommended real benchmark of 7% results in the NPV of real lease payments being less than the project costs.

Signed
Director-General
17 November 1997

Audit Office Comment

The response from the Attorney General's Department suggests that the Treasury recommended real benchmark of 7% results in the NPV of real lease payments being less than the project costs.

The response may infer also that that the application of the 7% (real) discount rate could have lead to a different audit conclusion on the substance of the transaction. This is not necessarily so. Firstly, the choice of a real discount rate ought not to be inconsistent with the prevailing interest rate climate. Secondly the application of the implicit rate in the lease (assessed at 10.65%) is in accordance with the requirements of the relevant accounting standard, which gives the resulting audit opinion. Neither rates differ materially.

Case Study 3:
Department of Agriculture, Orange

Background

The decentralisation of the then Department of Agriculture and Fisheries to Orange was announced by the then Premier in August 1989.

The move was said to produce the following advantages:

- enhancing the career prospects for regionally based department officers
- better offices for staff
- sharp reduction in Head Office accommodation costs
- easier access for staff to much of the State's farm industry
- more opportunity for a "hands-on" approach to agriculture
- better integration with the central western community
- a long-term boost for the regional economy.

The Economy of the Transaction

Lease Details

The Department of Agriculture's Head Office in Orange was constructed by Abigroup Ltd in 1990-91 on the basis of a 29 year lease entered into by the then Government, commencing 4 November 1991. On termination of the lease, the Department is to hand over the building to Abigroup in readiness for the next tenant.

Annual rental at commencement was $2.8m and is to be reviewed annually according to movements in the CPI. The Government as lessee is liable for all rates, taxes, utilities and outgoings for the property, as well as for all maintenance, replacement and repairs.

Audit Observations

At the implicit rate in the lease, the present value of minimum lease payments is 91% of the value of the land and building.

Using the NSW Treasury Corporation 10 year benchmark rate of 10.29% nominal (being the rate at the date the transaction was executed), then the NPV of the minimum lease payments represents 152% of the fair value of the land and building or over 50% greater than the cost of land and construction of the building had the Government decided to own/construct this building.

Similarly, at a discount rate of 13.5%, for a 29 year period the NPV of the minimum lease payments is equal to 113% of the fair value of the land and building (or 13% over the fair value).

In summary, these alternative discount rates suggest that the Government will, over the life of the lease, have paid effectively for the cost of land and construction of the building.

A preferable outcome, in terms of value for money, would have been for the Government to have purchased the building and land. DPWS concur with this view.

4 Core Functions

Overview

For certain agencies such as the Premier's Department, Cabinet Office and The Treasury, it is a sound argument that the functions undertaken by these agencies in one form or another are core or essential to an efficient and effective Government and have been so for many years.

The audit did not attempt to determine, and the report does not conclude on which functions or services of Government are core or essential.

Furthermore:

- a need to be in close proximity to key clients, namely the Parliament, Ministers and the Executive arm of Government
- the economic issue of long-term occupation for core functions

provide a rationale for the Government to own office accommodation for these agencies.

Given the results of research and financial analyses undertaken, it is considered that the cost of office accommodation from a whole-of-Government perspective could be reduced if some proportion of buildings were owned by the Government for its core, long-term office accommodation requirements.

Given the ongoing presence of government agencies in regional, including country NSW, the same core office accommodation argument can be mounted for ownership of office accommodation in these areas.

In certain circumstances, it may be better to lease accommodation for non-core agencies and/or activities subject to frequent change, and thereby maximise the short term flexibility that leasing provides.

4.1 Location of Office Accommodation

Head Office Accommodation

Of the total of 133[7] NSW Government agencies registered in the *DPWS Office Accommodation Database*, over 50% have Head Offices within the Sydney CBD, fringe CBD and lower North Shore areas of Sydney.

All 20 Ministerial Offices are located in these same areas.

Head Office Staff

About 84% of head office staff are located in the Sydney CBD and environs.

Table 4.1 Head Office Employee Distribution

Region	Agencies	No. of Head Office Staff [1]	% Head Office Staff	No. of Non-Head Office Staff [2]
CBD	**43**: 24 Budget, 9 Non-Budget, 10 GTEs	8,076	43.8	5,049
Fringe CBD	**19**: 17 Budget, 1 Non-Budget, 1 GTE	5,614	30.5	4,394
Lower North Shore	**9**: 6 Budget, 2 Non-Budget, 1 GTE	1,810	9.8	1,372
Total	**71**	**15,500**	**84.1**	**9,915**
Other [3]	15	2,929	5.9	n.a.

Source: DPWS *Discussion Paper Policy Formulation: Decentralisation*, 24 January 1997

Notes:

1. Defined as office-based jobs only, excluding police officers, teachers etc.
2. Defined as staff physically located separately from the agency CEO.
3. Inner West, West, South/South West, Newcastle, Wollongong and Country areas as defined in the DPWS Office Accommodation Database.

[7] As defined within the DPWS *Government Office Accommodation Database*. The precise number of government agencies is open to question given that some agency names in the database are either: duplicated (eg Maritime Services Board and the Sydney and Newcastle Ports Corporations - no mention of Port Kembla Ports Corporation) or obsolete (eg Department of Courts Administration, Public Employment Office).

Audit Observations

The concentration of Head Office/Ministerial offices in the CBD, together with the long-term nature of many of their functions, indicates that there is a long-term demand for office accommodation in close proximity to Parliament which would also necessitate a CBD location.

This long-term demand could often be met more economically in owned office accommodation.

The Audit Office does not conclude, however, as to whether the number of agencies and employees occupying premises within the CBD is appropriate.

4.2 CBD Strategic Plan & Core Accommodation Needs

CBD Strategic Plan

Refurbishment of the former State Office Block (SOB), and the Department of School Education and Chief Secretary's buildings, and leasing of 30,000 sqm of private sector office accommodation was designated as an integral component of the former PSG's *A Strategic Plan for NSW Government Office Accommodation - Sydney CBD 1993-2003.*

This strategy demonstrated the feasibility of aggregating the Government's activities within CBD buildings in the CPP portfolio, and placing approximately 30,000 sqm of anticipated office space into new private sector buildings on a staged basis and at minimal cost given the rental incentives then available in the market[8].

The objectives of this Plan included the:

- concentration of government activities within the confines of the City A1 Planning Precinct
- revitalisation of the Education and Chief Secretary's Buildings
- refurbishment of the SOB
- taking of the lease of Governor Macquarie Tower (GMT) - to act as a "holding area" pending the refurbishment of these buildings
- retirement from several long-term lease locations which were no longer suitable for government agency use.

[8] *Strategic Plan for Sydney CBD 1993-2003*, p 9.

The sale of the SOB was announced by the Government on 30 May 1996. The sale was confirmed on the grounds that the SOB was surplus to the Government's office accommodation requirements.

Governor Macquarie Tower

The Governor Macquarie Tower (GMT) comprises 42 levels providing 29,896 sqm of high standard office accommodation. There are 11 tenants of GMT, the major tenants are Treasury, Premier's Department, the Cabinet Office, Olympic Co-ordination Authority, Office of the Council on the Cost of Government and the Department of Urban Affairs and Planning.

Audit Observations

The significant number of core agencies housed within the GMT supports an argument that a need exists for core agencies to be accommodated in close proximity to Parliament and within the CBD area.

Whilst the analysis undertaken by the Government at the time outlined the costs and benefits associated with this particular deal, in the longer-term it is likely that the Government would have made greater savings from owning its own accommodation for core office requirements as identified in the CBD Strategic Plan, rather than pursuing the leasing option.

DPWS Comment

DPWS supports the proposition that the management of the CPP (of which GMT is a component), by pooling multiple occupancy office accommodation requirements, enables economies of scale to be achieved through wholesale dealing (Head leases). In turn savings can be passed on to occupying tenant agencies. This also allows the benefits of co-location by agencies where complementary services can be provided.

4.3 Alternative Arguments / Views on Core Accommodation Needs

NSW Commission of Audit Report

The NSW Commission of Audit's 1988 report *Focus on Reform: Report on the State's Finances*, advocated the

> *... retention of land and property on which essential services are provided and which involve key symbolic functions together with other specialised properties (such as schools and hospitals) where it may be difficult to establish a fair market value at which Government would lease from long-term investors ..*

It also stated that *... all other properties, including offices, should be sold ... and where required for Government activities, leased back on commercial terms.*

Audit Observation

The views espoused by the NSW Commission of Audit assumed that sale and leaseback arrangement would be more cost effective than retaining ownership in most cases. This view is not generally supported in the research and literature reviewed as part of this audit.

Victorian Commission of Audit Report (1993)

The Victorian Commission of Audit Report stated the view that it is:

> *... a fundamental role of government is to ensure that essential economic and social infrastructure is provided for the community, and that efficiency is best achieved if government purchases, on behalf of the community, the service outputs that arise out of the use of major infrastructure and other assets rather than providing them itself*[9].

This view is also consistent with the notion that it is preferable for Government to lease than own major public infrastructure such as office accommodation.

Core Business Argument

These views reflect what is termed the *core business* argument. That is, Government should devote relatively scarce capital to the achievement of the primary function; that is, the delivery of services to the public.

In accordance with this view, owning office buildings is not considered to be part of an agency or Government's core activities and therefore its limited resources and capital assets should not be tied up in building/owning assets.

Related to this argument is that many agencies do not have the necessary expertise in property management (as opposed to say State Property), and therefore agency ownership incurs a high risk in terms of its asset management. The risk, for example, of a mismatch between the location and size of office facilities and those specifically needed by an agency to achieve its strategic plan is also higher in the case of agency ownership.

The overall conclusion to be drawn from these "core business" arguments is that individual agencies should lease their office space requirements and not own.

The factors which lead to this conclusion, however, do not necessarily apply from a whole-of-government perspective or to a specialised accommodation agency such as State Property, whose core business is to manage property assets.

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9 *Report of the Victorian Commission of Audit*, Volume II, May 1993, p 260.

That is, given the results of previous research and financial analyses undertaken with respect to this issue, it is apparent that the cost of office accommodation from a whole-of-Government perspective could be reduced if some proportion of buildings were owned by the Government for its core, longer-term office accommodation requirements and then provided to agencies by way of commercial leasing arrangements.

4.4 Office Accommodation in non-CBD and Regional Areas

Approximately thirty-eight percent[10] of the NSW population resides in the non-Sydney metropolitan area.

There are seven regional centres in NSW with a population greater than 30,000 persons, with Newcastle, Wollongong, Wagga Wagga, Albury, Dubbo and Orange the largest regional hubs.

Given current technological service delivery mechanisms, residents of regional and country NSW often require local face-to-face access to Government funded services such as housing, community services, education, and land and water conservation.

The CPP in Regional/ Country Areas

The CPP *owns* 27 properties in the non-Sydney metropolitan area, amounting to 50,993 sqm (or around 16% of the CPP's portfolio).

The majority of the CPP properties (in terms of total numbers), both owned and leased, are located in regional and country areas. As noted earlier, one of the objectives of the CPP is:

> *... the provision and maintenance of operational accommodation in localities in which the State Government is active but where the quality, quantity or suitability of location is not available through the normal commercial market*[11].

[10] *CPP Annual Portfolio Plan: Strategic Plan Report*, July 1996, p 9.
[11] *CPP Annual Portfolio Plan: Strategic Plan Report*, July 1996, p 6.

The policy of co-locating government agencies within major government office blocks in regional areas during the late 1980s were claimed to provide a benefit to individual agencies, the public and the Government. Some of the potential benefits identified were:

- better conditions for agencies and the public in larger more modern office buildings
- a likely reduction in outgoings as a result of more efficient buildings
- public access to a range of services in close proximity
- an ability to reduce overall costs through using market power to negotiate a favourable pre-commitment lease on a new building or by constructing a government-owned building.

The location of government agencies can also impact positively on regional development through:

- locating agencies where they can be of maximum benefit to their clients, particular where face-to-face contact is desirable
- helping build efficient and competitive economies (promoting industrial "clusters" and "critical mass") by the strategic placement of government agencies.

Audit Observation

The core office accommodation argument, and its implications for ownership of long-term office requirements, can be extended also to regional, including country, locations.

That is, given the strong and often continuing presence of the government services in regional NSW, it can be more economical for Governments to own office accommodation rather than lease from the private market.

4.5 Factors that Impact on Core Office Accommodation

4.5.1 Recent and Future Asset Sales

In 1996-97, the proceeds from property asset sales are expected to be $364m, with around $500m[12] anticipated in 1997-98 as part of a wider Government strategy on asset sales. The aggregate asset sales program is expected to reduce to about $221m in 1998-99 and $136m the following year.

About $180m of the 1997-1998 revenue is expected to be generated from CPP sales (such as the St James Centre), and $142m from the sale of property assets within budget sector agencies. The balance will be made up from the sale of non-budget sector agency property assets; for example, the Energy Australia headquarters on the corner of George and Bathurst Streets, Sydney.

In this context it is noted that the Commonwealth Government has also announced a two-year divestment program of commercial property sales estimated to be worth $800m[13]

Other things being equal, a continuous decline in the infrastructure asset base will increase the Government's need to lease office accommodation.

> *As a result of the sale of Government buildings within the CBD, in particular the State Office Block, and the proposed future sale of St James Centre and Bligh House the quality and location of stock within the CBD has diminished.*[14]

The Annual Portfolio Plan (1996-97) of the CPP also noted these changes and commented that:

> *... over the last 18 months a significant shift had occurred in the balance between owned and leased accommodation, with two-thirds of the portfolio space now leased.*

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12 *Australian Financial Review*, 7 May 1997.
13 *Australian Financial Review*, 13 October 1997.
14 Internal Treasury Minute, 6 September 1996.

The following are examples of recent asset sales of property.

Hyde Park (Pacific Power) Tower

In September 1996, approval was given by Treasury for State Property to enter into negotiations with Pacific Power for a 10 year head lease/leaseback arrangement for its existing areas occupied in the Hyde Park (Pacific Power) Tower building. Simultaneously the Treasurer announced that the Pacific Power building was for sale.

This decision was undertaken on the basis that:

> *The proposed head lease and lease back arrangements will enable a higher sale price being received for the property whilst also allowing the relocation of various government agencies to superior accommodation at comparable rental costs*[15].

On 10 April 1997 it was announced that the Hyde Park Tower had been sold to a developer consortium for $155.25m. The sale was described as a *move* [which] *was in line with the Government's policy of divesting itself of non-strategic properties*[16].

St James Centre

During March 1997, the Government marketed the St James Centre on the basis of a five year lease to the Government and a sale on either a freehold or 99 year leasehold basis. The building was sold in 1996-97, resulting in settlement in July 1997, for a price of $48m.

Like the Pacific Power building, the St James Centre will continue to be managed as a leased premise under its new ownership. This reflects a recent trend, sanctioned by Treasury, towards "signing-up" government client leases, prior to sale, in an attempt to maximise sale proceeds. A similar practice has been adopted by the Commonwealth Government.

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[15] Internal Treasury Minute, 6 September 1996.

[16] Treasurer Media Release, 23 September 1996.

Audit Observations

Any asset sales strategy undertaken on the basis of assets established to be surplus to requirements could be considered prudent in terms of alternative use of resources, for example, the retirement of State debt.

It has been argued previously by State Property, however, that this principle has not been predominant in the decisions of Government made in the context of the recent asset sales agenda:

> *The acquisition of new space and the disposal of existing space is not often driven by the requirements of tenant departments/agencies.*
>
> *Pressure to dispose of properties has arisen from whole-of-government budgetary imperatives irrespective of their operational and economic suitability to meet tenant needs. This has resulted in 'passive' portfolio management strategies (as opposed to proactive strategies) being developed to meet the accommodation requirements of these tenants*[17].

Documentation reviewed by The Audit Office indicates that both State Property and Treasury regarded the Pacific Power building as representing an efficient, well located building which could provide continuing stock to satisfy agency demands for office accommodation in the Sydney CBD area.

Its subsequent sale and leaseback has meant that effective strategic control has now been lost in respect to this asset, for what could be considered a core office accommodation building.

Apart from these considerations, major asset sales programs do provide a benefit to Government but it may be short-term.

In the longer-term, however, the Government is exposed to the risks of fluctuating market conditions, and as noted previously, is ultimately a more expensive option than if the Government had owned office accommodation for its longer-term requirements.

[17] State Property, *Crown Property Portfolio Annual Portfolio Plan: Part 1 Strategic Plan Report*, July 1996, p28. DPWS have questioned whether these statements remain valid (as at October 1997) given the changes that have occurred in property and financial markets.

The practice of sale and leaseback involves swapping future lease payments by the Government for a current capital payment to the Government. If the discount rate implicit in the lease is less favourable than that applicable to Government, the apparent benefit to the budget from a capital receipt would be illusory.

4.5.2 Decentralisation

Since the early 1990s, successive Governments have advocated a policy of devolving public sector agencies/employment to a limited number of "centres" across Sydney.

One objective of this policy was to offset the increase in unemployment in these areas, occurring in part due to the decline in industrial growth in the western and southern regions of the Sydney metropolitan area.

Implementation of the policy led to the relocation of around 7,000-7,500 (20%) of the then Sydney CBD-based public sector employees to western Sydney during the late 1980s, with Parramatta (4,500 jobs) and Liverpool (1,000 jobs) the major recipients. Further relocations occurred during the early 1990s.

Parramatta

The western region of Sydney has a population in excess of 750,000, with the City of Parramatta, a major commercial business district, being serviced by 33 government agencies, occupying around 91,000 sqm in 31 tenancies over 18 premises. Forecasts indicate significant workforce and residential growth in the western Sydney region over the next 20 years.

The average cost of space is $280/sqm per annum. The total cost ascribed to office accommodation in Parramatta is $16.4m p.a.

Details of the *major* government agency tenancies in Parramatta are as follows:

Table 4.2: Major Government Tenancies in Parramatta, as at December 1996

Agency	Area Occupied sqm	Lease Expiry
NSW Police Service	15,711	19/7/2004
Department of Land & Water Conservation	12,482	31/12/1997
Department of School Education	11,032	31/5/1999
Office of State Revenue	8,750	30/11/2001
State Rail Authority	8,744	31/1/1998
Department of Fair Trading	6,800	31/5/2003
Roads & Traffic Authority	3,223	n.a.
Department of Urban Affairs and Planning	1,691 1,194	31/5/2003 31/12/1997
Department of Housing	2,607	30/9/2001
Total	**72,234**	**n.a.**

Source: *Parramatta Office Accommodation Strategy*, DPWS, December 1996

Audit Observations

No owned office accommodation exists currently in Parramatta even though it could be argued that certain core, longer-term functions are undertaken at Parramatta.

Based on

- the requirement for accommodating a range of functions and staff in Parramatta, with forecasts indicating significant workforce and residential growth in western Sydney region over the next twenty years and
- given the expiry by the year 2000 of large areas subject to lease,

a case exists for the Government to examine the ownership of office accommodation in this major metropolitan centre.

4.5.3 The Workplace and Future Technology

Currently there are significant changes taking place within the property industry that will significantly impact on the way space is used. These changes relate to incorporating new technology, changing work practices and new developments within the interior design and construction capability of buildings, which may, in the medium to long term result in significantly different requirements.

Broadly, new concepts such as “hotelling”, “hot desking” and “telecommuting” - see Glossary for further details - could lead to significant reductions in the amount of physical space required. Inherently this will mean that a flexible, leased portfolio of office accommodation of shorter duration than currently exists may prove to be beneficial from a whole-of-Government perspective.

5. Office Accommodation: A Profile

Overview

Government agencies occupy 1.14m square metres (sqm) of office space across New South Wales. Half this space is leased.

The annual cost of floor space (in terms of rent and rent equivalent) is $202.3m, defined in terms of the ascribed annual gross rent in both leased and owned[18] premises.

Sydney CBD accounts for 36.4% of the Government's leased office accommodation and carries the highest rent burden of $310 per sqm.

Approximately 92% of the total number of leases have either expired or will expire by the year 2000. This presents financial implications for the Government particularly in a rising rental market.

Some experts predict that rents will double by the year 2005. This situation is compounded by a trend to sell owned office accommodation and for Government to occupy leased premises rather than to own.

It should be noted that the data analysis contained in this section of the report is sourced from the DPWS Government Accommodation Database as at March 1997 based largely on 1996 information. Data collection for 1997 returns are expected to be finalised by November 1997.

[18] Accurate rental data on government-owned facilities do not exist on the DPWS Government Office Accommodation Database (*NSW Strategic Accommodation Masterplan*, p14-15). However, DPWS are taking steps to address this issue (refer to section *5.7 The Office Accommodation Database).*

5.1 Floor Space

Distribution of Office Space

The majority (78%) of the 1.14m (sqm) of floor space, owned and leased by the Government, is in the Sydney CBD and Greater Sydney Region.

The division of office accommodation, in terms of area occupied, can be seen in the table below:

Table 5.1: NSW Government Office Accommodation

Region	Area (sqm)	% of Total Area
Sydney CBD	485,592	42.7
Greater Sydney	401,022	35.3
Country	250,646	22.0
Total	1,137,260	100.0

Source: DPWS Government Office Accommodation Database

Notes:

1. Regional classifications used throughout this report are based on Department of Public Works and Services (DPWS) and Australian Bureau of Statistics statistical divisions and sub-divisions.
2. Sydney CBD is not included within the Greater Sydney Region.

Condition of CBD Office Space

As indicated in Figure 5.1 overleaf, the majority of total Sydney CBD office stock is categorised as being of Grade A, B and C standard[19] (84.8%), as is the majority of the Government's office stock (85.6%).

However, within these gradings the distribution of stock varies, with 76.8% of the Government's portfolio concentrated in B and C Grade accommodation, compared with only 55.4% of the total CBD stock.

[19] See Glossary of Terms in Appendix 6.5 for explanation of gradings.

Figure 5.1: Percentage of Sydney CBD Area by Grade

Source: State Property Branch, DPWS, *A Strategic Plan for Sydney CBD, Part 1 - Action Plan*, May 1996

The figures above indicate that a large percentage of agencies occupy space (both owned and leased) in lesser graded stock. For example, the CPP has an ageing stock of *owned* CBD accommodation within the CBD. Major CBD *leases* in buildings such as 1 Francis Street and 323 Castlereagh Street are not likely to be renewed when current leases expire due to the relatively poor quality of this accommodation[20].

Area Occupied by Government Agencies

The top ten agencies, in terms of area occupied, occupy almost half of the Government's total stock, that is over 500,000 sqm, while the top five agencies occupy over 300,000 sqm (29%).

Conversely, the smallest 108 agencies, defined in terms of area, account for only 28% of total stock.

5.2 Workspace Ratio

The workspace ratio *across NSW*, defined as the average area occupied per Government employee, was 22.7 sqm at the time the analysis was undertaken. The Government has an overall objective of decreasing this average across all agencies:

> *In the short term the Government's target is to reduce the average utilisation of office space across the NSW public sector ...... to 18sqm per employee*[21].

[20] State Property, *Internal Memorandum*, 21 October 1996.
[21] Premier's Memorandum No.-97-2, *Government Office Accommodation and Property Disposal*, 12 February 1997.

5.3 Lease s

The 1.14m square metres of office space occupied currently by agencies is divided equally between leased and owned accommodation (49.9% and 50.1% respectively).

The division between leased and owned premises by region in NSW (in terms of area) is demonstrated below:

Figure 5.2: Own v Lease (Area), by Region

Source: DPWS Government Office Accommodation Database

To a large extent the situation in the Sydney CBD, where 57.5% of government office accommodation is owned, has developed by historical accident rather than on any conscious decision by successive Governments to develop a pre-determined own-to-lease portfolio mix.

The 1990s trend towards divestiture of key Sydney CBD-owned buildings (for example, McKell Building, State Office Block) and a greater recourse to leasing (for example, the Government's 29,894 sqm lease on Governor Macquarie Tower) will serve to alter the current own/lease balance.

Section *4. Core Functions* discusses recent and future asset sales and the impact on the need for government office accommodation.

Distribution of Leased Properties

In terms of the *number of leases* held by Government, over 57% are in the country area, 27% are in the Greater Sydney Region, and less than 16% are in the Sydney CBD.

However, in terms of *area* and *annual gross rent*, almost half of the office accommodation leased across NSW is in the Greater Sydney Region (43% of area and 44% of gross rent). Sydney CBD accounts for 36.4% of leased area and 40.1% of gross rent, while country NSW accounts for only 21% of leased space and 16% of gross rent.

Lease Profile

The profile of properties leased by the Government[22] indicates that approximately 92% of the total number of all leases have either expired (but continue to be tenanted by Government agencies) or will expire by the end of the year 2000.

Expired Leases

Table 5.2: Lease Profile

Period to Expiry (years)	No. of Leases due to Expire	No. of Leases as % of Total	Gross Rent of Leases due to Expire ($'000/pa)	Gross Rent of Leases as % of Total
Expired[23]	283	24.2	19,725	10.3
<=5	790	67.6	114,817	59.9
6-10	63	5.4	24,221	12.6
11-15	21	1.8	24,040	12.5
16-20	0	0.0	0	0.0
21-25	10	0.9	8,849	4.6
26-55	0	0.0	0	0.0
>=56	1	0.1	141	0.1
Total	1,168	100.0	191,793	100.0

Source: DPWS Government Office Accommodation Database

As indicated in *Table 5.2 Lease Profile*, 24.2% of the *total* number of leases held by the Government have expired although the office accommodation continues to be occupied by agencies on a month-to-month tenancy basis.

This is consistent with the finding of the DPWS Internal Audit Report on the State Property Branch (29 November 1996), which noted that not all tenants had signed lease agreements.

[22] This profile comprises *all leases* held by Government, both with private sector landlords and other government agencies.
[23] Expired leases are those leases that expired during, or prior to, 1995.

Within the CPP, DPWS is taking steps to address the issue of lease administration, including expired and expiring leases, with the promotion of a simplified tenancy agreement. The purpose of this initiative, within the CPP, is to enhance portfolio management by ensuring that tenants are aware of the terms and conditions of leasing arrangements which should be consistent with the current market. However, outside the CPP, DPWS may only advise agencies on lease negotiations.

Within the CPP, DPWS do not control negotiations and have a mandate only to initiate new/renewed lease arrangements (30% of the Government's total portfolio).

DPWS Comment

In commenting upon the figures above, DPWS have made the distinction between *commercial* leases, which the Government holds with private landlords, and *CPP tenancy* (government-to-government agency) agreements. On this basis, of the 283 (24.2%) expired leases, identified as at the end of 1995, 218 relate to CPP tenancy agreements and 65 were commercial leases.

DPWS also commented that the expiration of these CPP tenancy agreements is not of concern for they do:

> *....not expose the government financially as in the final analysis Treasury, by exercising its executive powers, would impose a decision on a maverick government tenant.*[24]

Adopting this narrower definition, the expired/expiring leases situation for non-CPP properties (as at 16 October 1997[25]) is as follows:

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[24] Comments on draft report provided by DPWS to The Audit Office, 17 October 1997.

[25] Status of figures is as at the end of 1995, although the number of expired/expiring leases may have varied slightly since the figures used in compiling Table 5.2 were extracted from the database (April 1997).

Expired Commercial Leases

Table 5.3: Lease Profile (Commercial Leases only)				
Period to Expiry (years)	**No. of Leases due to Expire**	**No. of Leases as % of Total**	**Gross Rent of Leases due to Expire ($'000/pa)**	**Gross Rent of Leases as % of Total**
Expired[26]	65	7.1	1,650	1.2
<=5	699	76.1	81,673	58.7
6-10	124	13.5	32,885	23.6
11-15	25	2.7	19,885	14.3
16-20	0	0.0	0	0.0
21-25	3	0.3	3,010	2.2
26-55	2	0.2	n.a.	0.0
>=56	1	0.1	142	0.1
Total	919	100.0	139,244	100.0

Source: DPWS Government Office Accommodation Database
n.a. Not available

On this revised basis, 83% of the total number of all leases have either expired (but continue to be tenanted by Government agencies) or will expire by the end of the year 2000.

Audit Observations

In the short-term, month-to-month tenancies may be acceptable in certain circumstances, such as a pending vacation of the premises or the negotiations for extension of the lease may not be completed. However, longer-term occupation of premises on a month-to-month tenancy basis could expose agencies, and consequently the Government, to risk in terms of termination of the lease agreements at short notice.

DPWS has advised that government to government leases may entail less risk in terms of security of tenure or increased rentals. It is nonetheless important in the interests of better portfolio management to ensure tenants are aware of the terms and conditions of leasing arrangements. In other words, having current tenancy agreements which reflect market conditions in terms of rent payable and receivable would ensure the maintenance of rental rates commensurate with market movements and thereby maximise the Government's return on its significant asset portfolio.

[26] Expired leases are those leases that expired during, or prior to, 1995.

A better, more up-to-date delineation of an agency's cost of operations would also result from this action.

DPWS has taken steps to improve portfolio management with the formalisation of the leasing arrangements and that they are consistent with the current market.

Long-term Leases

The majority of leases (over 80%) held by the Government are for periods of 10 years or less. Eight leases are for 20 years or more. Of these, four leases are for greater than 25 years, and one lease is for 95 years (due to expire in 2052).

A discussion of the nature and risks inherent with the Government holding long-term leases, and the financing arrangements underpinning these leases, is included in section *3 Case Studies.*

DPWS Comment

DPWS have advised that, in managing the CPP, DPWS currently provides for no leases longer than 12 years. DPWS also seeks to avoid rental ratchet clauses within this portfolio and negotiates leases to ensure that the Government is exposed only to normal market increases.

5.4 Rent

Annual Rent

Annual gross rental payments on leased properties amount to $134.6m (of a total annual accommodation ascribed cost of $202.3m).

Table 5.4: Annual Gross Rent Paid on Leased Properties

Sydney CBD ($'000)	Greater Sydney ($'000)	Country ($'000)	Total ($'000)
54,015	59,501	21,070	134,585

Source: DPWS Government Office Accommodation Database

Rent Per Square Metre

Rental rates vary significantly across NSW, ranging from an average of $171/sqm in country locations, $248/sqm in the Greater Sydney Region, and an average $310/sqm in the Sydney CBD.

These rents, however, compare favourably with the property market in total, where the average gross face rent for the Sydney CBD as at December 1996 was $517/sqm, and ranged between $280/sqm and $375/sqm for the Greater Sydney Region.

5.5 Relationship Between Rents and Leases

Rents have increased since the latter half of 1993, when gross effective rents in the Sydney CBD averaged less than $200/sqm.

Although opinions differ, some market forecasters[27] were predicting in the first half of 1997 that rents in the CBD would double by the year 2005.

Audit Observations

Continuing rental growth has implications for the Government's office accommodation portfolio.

Should these market forecasts prove correct, the Government could potentially face an annual rental increase in excess of $100m in the CBD alone assuming existing occupancy levels.

5.6 Crown Property Portfolio

The Crown Property Portfolio (CPP) accounts for approximately 30% of occupied office accommodation in NSW. The portfolio consists of both owned and leased properties tenanted by two or more government agencies.

Distribution of CPP Properties

In terms of numbers, most properties in the CPP are located in the country (63%), while in terms of area, a majority of the space is in the Sydney CBD (53%).

CPP Vacancies

Vacancy rates are calculated only for CPP properties.

Table 5.5 below shows the overall vacancy level, and the division between owned and leased properties for the CPP.

Table 5.5: Crown Property Portfolio Vacancies

	Available Net Lettable Area (sqm)	Vacant Area (sqm)	Vacancy Level (%)
Portfolios 1-2 (owned)	114,582	5,892	5.1%
Portfolios 3-4 (leased)	199,914	3,431	1.7%
Total	314,496	9,323	3.0%

Source: *Crown Property Portfolio, Monthly Management Report 1996/97*, Portfolio Management Services Unit, December 1996

Note: Available Net Lettable Area is defined as net lettable area less withdrawn space.

The above data was sourced from a report provided by DPWS to Treasury in December 1996.

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[27] For example: BIS Shrapnel Pty Limited, *Sydney Commercial Property Market Forecasts and Strategies*, Sydney, January 1997

DPWS Comment

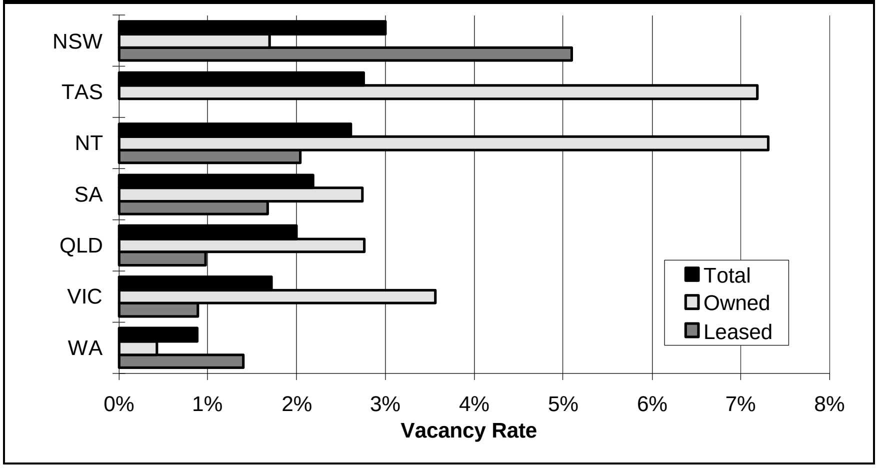
DPWS has advised that the vacant area figures include property that is considered by DPWS to be unlettable due to operational or strategic reasons, such as asbestos danger or impending sale.

When these properties are excluded, the *total* vacancy level for Portfolios 1 to 4 is 2.1% for the corresponding period.

Audit Observations

As evident in Figure 5.3 overleaf, the CPP within NSW has the highest total vacancy rate in comparison with other State/Territory Governments.

Figure 5.3: Comparison of *Managed* Portfolio Vacancy Rates



Source(s):

1. The Government Real Estate Managers Group, *National Benchmarking Survey Report*, October 1996
2. *Crown Property Portfolio, Monthly Management Report 1996/97*, Portfolio Management Services Unit, December 1996

5.7 The Office Accommodation Database

The Government Office Accommodation Database (the database), is managed by State Property and contains information on all office accommodation owned and leased by Government agencies, with the exception of a number of properties that are owned directly by an agency.

The database is designed as a management tool to assist in facilities management and the overall strategic management of office accommodation.

The database is updated annually by an Office Accommodation Survey of all government agencies.

The survey includes about 1,400 tenancies from 133 registered agencies and requests various details such as building type, area occupied, vacancies, rental terms, valuation, basis of tenancy, lease terms, etc.

The CPP portion of the database is also periodically updated on advice from the private sector contractor responsible for managing a portion of the portfolio, as and when accommodation changes occur. Information for CPP reports produced by DPWS, such as those to Treasury and the *Annual Portfolio Plan*, are sourced from the operational data maintained by the private sector contractor.

The Survey

Agencies are under no legal obligation to complete and return the surveys or to guarantee the accuracy of information contained therein.

This situation is expected to improve with the issue of Premier's Memorandum *No.-97-2 Government Office Accommodation and Property Disposal*, which requires all agencies to provide information annually in a more detailed and disciplined form as part of a Total Asset Management Strategy, and with implementation of the recommendations contained in this report.

Accuracy of the Database

Historically the database has not been reliable because:

- agencies were not obliged to return surveys
- agencies were not held accountable for the accuracy of information provided
- information was generally only updated once a year, but if an agency changed location the database may have been amended as a result of that change
- in the case of the CPP, data was updated irregularly whenever advice was received from the private contractor
- inadequate definitions or definitions which were not understood. There appears to have been some confusion among government agencies as to what is meant by "office accommodation". For example, many agencies when approached by The Audit Office, were not clear as to whether the definition is meant to include offices located in operational areas (police stations, works depots) or whether the definition is limited to facilities used for designated office accommodation purposes only

- by way of example and based on data sourced from the database, the CPP's *Annual Portfolio Plan* for leased office accommodation notes the Department of School Education's (DSE) accommodation at Signature Tower, 2-10 Wentworth Street, Parramatta to have a nil vacancy level as at 1 July 1996. Other evidence, however, suggests this to be not the case, with a large backfill program in operation as a result of locational changes caused by the restructuring of DSE during 1996.

Another limitation of the database is that historical data is very difficult to extract, making intra-year comparisons and data trend analysis difficult and potentially misleading. For example, State Property were not able to provide pre-1996 data when requested to do so by The Audit Office.

A 1996 DPWS Internal Audit Report noted instances of inaccuracies or omissions in reports submitted for the CPP based on data extracted from the database.

Treasury has also exchanged correspondence with State Property in recent years seeking to improve the quality of data and benchmark performance reporting of the CPP.

Audit Observations

In aggregate, the above factors have the potential of presenting an incomplete picture of office accommodation as evidenced by the following discrepancies:

- different figures have been quoted within DPWS and by it to third parties (such as to the Minister for Public Works and Services and the Government)
- State Property quote an average space ratio of 22.7 sqm per person, a net figure, while Policy Division report the workspace ratio as a gross figure of approximately 24 sqm per person
- vacancy rates are not calculated across the whole of the Government's office accommodation portfolio, despite details of vacant space being collected via the annual database survey of around 1,400 tenancies. This is due to the suspected inaccuracy of information as supplied by agencies and the fact that DPWS regard it to be more meaningful, from an analysis viewpoint, to prepare vacancy surveys on a monthly basis rather than at ad hoc, irregular intervals.

In response to this latter comment, an internal DPWS memorandum dated 8 October 1997 states:

> *Although the annual office accommodation survey seeks to establish what space is unoccupied at the time of the survey (as indeed it seeks a wide range of potentially useful data which have been requested at various times by users), it makes no pretence at being a current and accurate record of vacancy data*[28].

DPWS Comment

DPWS has advised that steps have been taken to address the issue of the inadequacies of the database and the definitions contained therein, by:

- ensuring that reporting on the CPP by the private contractor occurs on a monthly basis
- the development and distribution, by State Property, of *The 1997 Survey - A Guide* with the 1997 Office Accommodation Survey, which is expected to result in improved database accuracy as from 1997
- increased accessibility of historical data
- ensuring all office buildings, within the CPP, are recorded on a CAD system and each office floor (tenancy) is measured in accordance with the Property Council of Australia's office measurement standard, which is reconciled with accurate surveyed floor plans and tenancy details
- establishment of an agreed workspace ratio definition across the organisation.

DPWS plans to instigate a program of rolling audits of 20% of the database annually to assess its accuracy and report back to agencies.

In addition, the requirement that agencies now submit Strategic Office Accommodation Management Plans to DPWS should assist in maintaining or verifying the integrity of the database.

Comparison of Database Returns

The Audit Office carried out a survey of a sample of agencies by requesting data on key indicators such as area occupied and rental payments as at 31 March 1996 and 31 March 1997.

Of the fifteen agencies surveyed, only three agencies returned 1996 data, complete, as requested.

[28] Internal DPWS memorandum, 8 October 1997.

A comparison of the 1996 data obtained from the database to the information supplied by two[29] agencies (to The Audit Office) shows a material variation between key indicators.

The variations noted are:

Area Occupied

- data for area occupied for both agencies differed by 18% (higher) and 61% (lower) when compared to that recorded by the database.

Rent

- there is also considerable variation in the database data for rent paid by the agency, due to the differences in area occupied. Annual rent, on office accommodation, paid by agency 1 (as per the agency return) is over 15% higher than that detailed on the database. For agency 2, the figure returned by the agency is over 23% lower than the database figure.

Audit Observation

Any doubt in regard to the reliability of the database maintained by State Property has implications for the management of the property portfolio including the quality of advice given to Government.

The same would be true of individual agency's management of this key resource.

[29] The two agencies detailed in this section (of the three that returned 1996 data as requested) are among the top eight largest users of office accommodation, in terms of area occupied.

6 Appendices

6.1 Audit Objectives and Approach

Audit Objectives

The audit objectives are:

- to provide a profile of office accommodation in NSW and
- to examine the issues relevant to the question of the ownership versus leasing of office accommodation requirements.

Audit Approach

The Audit Office reviewed the research papers, reports, data sources and file documentation held by the Department of Public Works and Services (DPWS) and NSW Treasury relevant to these key audit objectives.

Similar documentation was sourced from the Department of School Education, DPWS, Department of Agriculture and the Department of Land and Water Conservation, in relation to the review of the leasing arrangements as detailed in section 3. *Case Studies*.

A number of other sources of information were utilised in the course of the audit, particularly in relation to private sector research and analysis on office accommodation matters. For example, publications produced by the Property Council of Australia (formally the Building Owner's Management Association - BOMA), Jones Lang Wootton Pty Ltd and BIS Schrapnel Pty Ltd were regularly referred to in the course of the audit.

A listing of these other sources of information is contained in *Appendix 6.7 - Bibliography*.

6.2 Research on the Question of Ownership vs Leasing

Overview

In general, most research conducted into the question of own vs leasing office accommodation (including that by several Australian State Governments) has indicated that, except in particular circumstances like those which occurred in the 1980s property boom, owning office accommodation is more cost effective than leasing.

Moreover, ownership of office accommodation buildings is considered to be the preferred method of providing for the longer-term core office accommodation needs of Government, with leasing used as a method of providing for short to medium term needs and flexibility.

This conclusion has also been supported by the further advantage attributed to Government ownership; that is, of agencies having access to attractive borrowing rates through their central borrowing authorities, such as T Corp.

Jones Lang Wootton (1986)

Using the Discounted Cash Flow technique, the JLW study concluded that there is no definitive answer on whether leasing or owning is more favourable. Instead, JLW argue that an analysis should be undertaken for each project using realistic values for the input variables given the market conditions at the time.

Robinson (1989)

Robinson (1989), based on a sale and leaseback analysis of a hypothetical office building over tenure periods of between 5 and 20 years, concluded that owning was more favourable than leasing for each assumed tenure period and became more favourable as the tenure period increased.

Victorian Department of Management and Budget (1986)

A comprehensive study by the then Victorian Department of Management and Budget, again utilising a DCF model and applied to case study data from thirteen buildings (assuming tenure periods ranging from 1 to 30 years, three different discount rates, and four growth rates for rent and outgoings), indicated that on the whole, purchase seemed more favourable than leasing.

However, cases did occur where the tenure period became a critical factor and for this reason no general decision rule was recommended.

Consistent with the JLW study referred to earlier, major predictors identified in this study were:

- as rental growth rates increase, owning becomes more favourable (ie as per current market conditions)
- as the capitalisation rate increases, leasing becomes more favourable
- as the interest/discount rate increases, leasing becomes more favourable

SACON (1989)

The then South Australian Department of Housing and Construction (SACON) study concluded that owning was generally more favourable than leasing (in five of the seven properties subjected to DCF analysis).

Although SACON concluded that no general rule could be postulated, they did however suggest that in periods of low inflation and low interest rates [ie as per current market conditions] it may be better to own than lease.

SACON noted that the main factors which affect the decision to own or lease are the current cost of capital (reflected in the discount rate) and the anticipated growth in the value of the property.

> *In addition, where the gross cost of leasing is relatively low (say less than 10% of property values), then the cost of leasing is likely to be less than the opportunity cost of owning. In these cases, leasing the property would be the preferred option.*

The SACON study also noted that:

> *In country locations the net rental tends to be a higher percentage of the property value than in metropolitan and city locations. This tends to negate the benefit of leasing in the country, where property values are generally lower than elsewhere.*

This comment is explored further in section *4. Core Functions* when considering the issues of the Government's long-term core accommodation requirements in country and regional areas.

National Ireland Audit Office (NIAO)

The NIAO's report, *Provision and Management of Government Office Accommodation in Northern Ireland,* noted that the UK Department of the Environment (DOE) used an economic appraisal process to identify the most cost-effective option for acquiring property, and in most cases, such appraisals confirmed that ownership provided the lowest cost option.

Moreover, the DOE aims to meet its long-term accommodation requirements through the provision of owned accommodation and only to lease when ownership was not attainable, or when circumstances, such as the lack of funds or time constraints, made leasing preferable.

Queensland Department of Public Works and Housing (1996) View on Own vs Lease

According to the Queensland Department of Public Works and Housing:

> *... all other things being equal, there is a strong case for the Government to build its major assets new and own them outright.*

The reasoning behind this [not all supported by The Audit Office] *is:*

i. *the (typical) very long life cycle of government use*

ii. *the ability to build-in specialist facilities and to build to an appropriate standard*

iii. *the ability to be site specific*

iv. *access to capital funding at below market rates*

v. *the ability to secure developer's profits and (for political and economic reasons) take advantage of property cycles*

vi. *the inability of governments to obtain the taxation advantages of leasing costs and their exemption from Capital Gains Taxation*

vii. *the certainty of ownership, long-term planning and the ability to change and vary the asset at will.*

6.3 Sydney CBD Office Accommodation

The above CBD sector classifications are based on DPWS and Property Council of Australia sectors.

The Central Business District of Sydney is defined as the area bounded by Circular Quay to the North (as shown, to the right of the page), Darling Harbour to the West, Central Railway/Broadway and Kippax Street to the South and Bourke Street to the East.

The 485,592 sqm of Government occupied space in the Sydney CBD, which accounts for approximately 12% of the total of both private and Government office accommodation stock in the Sydney CBD, is split between six sectors as follows:

Table 2: Sydney CBD Office Accommodation

	Government Office Space Sydney CBD		**Total (Private and Govt) Office Space Sydney CBD**
CBD Sector[1]	**Sydney CBD Area (sqm)**	**% of Sydney CBD Area**	**% of Total Sydney CBD Area**
Mid Town	153,986	31.7	21.3
City Core	123,062	25.4	48.6
Eastern CBD[2]	36,876	7.6	--
Southern CBD	88,849	18.3	7.3
Western CBD	65,141	13.4	21.7
The Rocks	17,678	3.6	1.1
Total	485,592	100.0	100.0

Sources:

1. Property Council of Australia, *Australian Office Market Report*, January 1997
2. DPWS Government Office Accommodation Database

Notes:

1. Sydney CBD sector classifications are based on DPWS and Property Council of Australia defined sectors.
2. Eastern CBD is a sector created by DPWS for administrative purposes. There is no equivalent Property Council of Australia Sydney CBD sector.

6.4 The Top Ten Agencies

The top ten agencies, in order of greatest utilisation of office accommodation space, are:

- Department of Land and Water Conservation
- Department of School Education
- Attorney General's Department
- Roads and Traffic Authority
- Department of Public Works and Services
- Department of Community Services
- NSW Police Service
- Department of Housing
- State Rail Authority
- Sydney Water.

6.5 Glossary of Terms

Agency

The DPWS Office Accommodation Database includes 133 agencies, which encompass various forms of government, such as Departments, Boards, Tribunals, Statutory Bodies, State Owned Corporations and Ministries.

Building Grades

	Size	***Floor Plate***	***Age/Services/Finish***
Premium	> 20,000 sqm	> 1,100 sqm, largely column free	Top quality modern space which is generally a pace setter in establishing rents and includes: • the latest or recent generation of building services • ample natural lighting • good views/outlook • prestige lobby finish • quality access to/from an attractive street setting
A Grade	> 6,000 sqm	> 600 sqm, largely column free	High quality modern space including: • good view/outlook • quality lobby finish • quality access to/from an attractive street environment
B Grade	any size	any size	Good quality modern space
C Grade	any size	any size	Older style air conditioned space
D Grade	any size	any size	Poor quality space

Face Rent

The par or initial declared rental rate offered, without any allowance for incentives.

Gross Rent

Rent including all outgoings ie costs associated with the building which are passed on by the owner to the lessee such as maintenance and repair costs, administrative costs, management fees, rates, taxes, insurance, light, power, fuel, security and cleaning costs.

Hot Desking

The practice of sharing dedicated workspaces between two or more persons.

Hotelling

The practice of allocating available workspaces on demand to employees or others when required.

Interest rate implicit in the lease

The interest rate that causes the present value, at the beginning of the lease term, of:

(i) the minimum lease payments, and

(ii) any unguaranteed residual value expected to accrue to the benefit of the lessor at the end of the lease term

to be equal to the fair value of the leased property at the inception of the lease. [*AAS17 "Accounting for Leases"*, para 5 (l)]

Information Kiosk

An Information Kiosk refers to a terminal or a battery of terminals which allows automated customer access to information services in such locations as retail centres and selected Local Government facilities eg libraries.

Lease

A formal contract that transfers the occupation of a property or area of a property to the lessee for a set period of time, and under predetermined terms, nominated in the document.

Net Lettable Area

The area on which rent can be applied, including column areas, but excluding toilets, plant rooms and lifts.

Office Space

Space used for normal office functions. It would normally be occupied by work stations or desks, but could include reception areas, conference/amenities facilities for staff and records/stationery areas where they are used by only the one agency in the course of its usual business. Office space includes space used for retail purposes where this is a minor function of the agency.

Ratchet Clause

A minimum rental provision in leases which protects the lessor from a drop in rental below an agreed lower limit in the event of a reduced market value. Has effect during rent reviews.

Rent

Annual amount charged for the office area covered by a financial arrangements (usually a lease).

Telecentres

A Telecentre is an office to which employees regularly report for work, often within close proximity of their home and thereby reducing commuting time. It comprises multiple agency representation with direct electronic links to respective central offices.

Telecommuting

Telecommuting is a work practice that allows employees to conduct their employment roles away from their employer's location. The telephone network (and related data exchange services) then becomes the usual form of communication with the employer.

Vacancy Rate The total net lettable area available minus the total net lettable area utilised, divided by the total net lettable area available less withdrawn space.

Workspace Ratio (Area/Person) The area of an occupancy in square metres divided by the number of full time (or equivalent) employees occupying the space. Also referred to as space utilisation rate.

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6.6 Acronyms

CAD	Computer Assisted Design/Drafting
CBD	Central Business District
CPP	Crown Property Portfolio
DoCA	(the former) Department of Courts Administration
DPWS	Department of Public Works and Services
DSE	Department of School Education
GMT	Governor Macquarie Tower
NLA	Net Lettable Area
NPV	Net Present Value
SOB	State Office Block
SQM	Square Metre(s)

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Department of Housing	*Public Housing Construction: Selected Management Matters*	5 December 1991
Police Service, Department of Corrective Services, Ambulance Service, Fire Brigades and Others	*Training and Development for the State's Disciplined Services: Stream 1 - Training Facilities*	24 September 1992
Public Servant Housing	*Rental and Management Aspects of Public Servant Housing*	28 September 1992
Police Service	*Air Travel Arrangements*	8 December 1992
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State Rail Authority	*Countrylink: A Review of Costs, Fare Levels, Concession Fares and CSO Arrangements*	10 December 1993
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