The Auditor-General
Audit Report No.1 2004–05
Performance Audit

Sale and Leaseback of the Australian Defence College Weston Creek

Department of Defence

Australian National Audit Office

ISSN 1036–7632

ISBN 0 642 80792 2

Australian National
Audit Office

Canberra ACT
8 July 2004

Dear Mr President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit in the Department of Defence in accordance with the authority contained in the *Auditor-General Act 1997*. Pursuant to Senate Standing Order 166 relating to the presentation of documents when the Senate is not sitting, I present the report of this audit and the accompanying brochure. The report is titled *Sale and Leaseback of the Australian Defence College Weston Creek.*

Following its presentation and receipt, the report will be placed on the Australian National Audit Office's Homepage—http://www.anao.gov.au.

Yours sincerely

Oliver Winder
Acting Auditor-General

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

AUDITING FOR AUSTRALIA

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Abbreviations

AAS 17	Australian Accounting Standard 17
ACSC	Australian Command and Staff College
ADC	Australian Defence College
AGS	Australian Government Solicitor
AVO	Australian Valuation Office
CDSS	Centre for Defence and Strategic Studies
CPPs	Commonwealth Property Principles
CSIR	Corporate Services Infrastructure Requirement
Defence	Department of Defence
DISC	Defence Infrastructure Sub-Committee
Finance	Department of Finance and Administration
GFA	Gross Floor Area
IDC	Inter-Departmental Committee
NLA	Net Lettable Area
NPV	Net Present Value
PCG	Project Control Group
PFI	Private Finance Initiative
PV	Present Value
RFT	Request for Tender
SPDE	Strategic Plan for the Defence Estate 1999
TEP	Tender Evaluation Plan
Treasury	Department of the Treasury

Summary and Recommendations

Summary

Introduction

1. The Department of Defence (Defence) provides formal tri-service training through the Australian Defence College (ADC), comprising the Weston Creek campus and the Australian Defence Force Academy (ADFA) in Campbell ACT. The 1997 Defence Reform Program identified a need for greater efficiency in officer education. In response, the ADC Weston Creek site was refurbished over the period 1999–2000 to 2001–02, at a cost of $26.2 million, to provide for co-location of all service officer training. A re-organised ADC commenced operations at the site on 1 January 2001.

2. The ADC Weston Creek property was one of 41 properties included in the Defence property disposals program for 2002–03. The property was advertised for sale with a 20 year lease, including an option for a further 10 year period, and initial rent of $2.2 million per annum with a fixed annual 3 per cent increase. The property sold in May 2003 for $31.7 million, inclusive of GST. The 20 year lease commenced between the Commonwealth, represented by Defence, and the new owner on 13 June 2003. Defence is supplemented for the annual lease payments for the property. This was the second property disposal via sale and long term leaseback managed by Defence.[1]

Audit scope and objectives

3. The audit examined the process of identifying the ADC Weston Creek property for sale and leaseback and the management of the sales process, within the 2002–03 Defence property disposals program. The objective of the performance audit was to examine the efficiency and effectiveness of the management of the sale process by Defence. In particular, the audit assessed the effectiveness of the management of the sale process, including the extent to which the Government's sale objectives have been achieved; examined the long term sale and leaseback arrangements for the property and assessed whether they adequately protect the Commonwealth's interests; and identified principles of sound administrative practice to facilitate improved administrative arrangements for future Defence property sales.

[1] The first property sale and leaseback managed by Defence involved Campbell Park Offices in the ACT.

Key findings

2002–03 sales program

4. In the 2002–03 Budget, 41 Defence properties were approved for sale with a total revenue target of $659.5 million. Excluding the sale of Russell Offices in Canberra, to be managed by the Department of Finance and Administration (Finance), the Budget revenue target for Defence was $473.5 million. Proceeds from the property sales, up to the revenue target, were paid into consolidated Commonwealth revenue. Proceeds in excess of the target could be retained by Defence.

5. Defence achieved aggregate sale proceeds above the total of the market valuations for the properties sold. Aggregate proceeds also exceeded the Budget revenue target for 2002–03 by $104.5 million. Defence advised ANAO, in April 2004, that Finance had not yet agreed the proceeds to be retained by Defence from 2002–03 property sale proceeds.

6. A comparison of sale proceeds for Defence properties sold in 2002–03 with estimates supporting the Budget revenue target highlighted the need for revenue estimates, used as a basis for calculating the amount of proceeds to be retained by Defence, to be appropriately based and rigorously derived. For a number of properties, a low Budget revenue estimate compared to the properties' market valuations resulted in Defence potentially securing a significant windfall gain in funding. ANAO notes that a number of the Budget revenue estimates for individual properties significantly understated the value of the property. For example, one Sydney property was valued by the Australian Valuation Office (AVO) at more than 1 100 per cent of the Budget revenue estimate ($33 million) and a second at more than 47 per cent higher than the Budget revenue estimate ($49 million).

Business case

7. Defence engaged a firm to undertake business case analyses of the divestment strategies for 36 Defence properties identified for divestment in 2002–03. Five properties, including the ADC Weston Creek, were not reviewed. The report of July 2002 noted that no information was available on the ADC Weston Creek property for the firm to review. ANAO was unable to identify from Defence records any business case analysis to support a proposal to dispose of the ADC Weston Creek property from the Defence Estate through a sale and leaseback transaction. Nevertheless, a disposals strategy was developed for the sale process.

Appointment of advisers

8. A number of external advisers were engaged by Defence to assist in the sale and leaseback of the ADC Weston Creek property. A competitive tender process was followed for the engagement of only one of the advisers. Direct engagement of the other advisers was based on those advisers' earlier performance in the previous sale and leaseback of the Campbell Park property, managed by Defence.

9. ANAO found that the engagement of these advisers in the Campbell Park sale was also on a non-competitive basis. In that sale, direct engagement was approved to facilitate the completion of the sale in a tight timeframe and on the basis of assistance previously provided to Defence by those advisers and/or their inclusion on Defence panels. It was not identified, during the engagement process for the Campbell Park property sale, that those advisers would be appointed for the following sale of the ADC Weston Creek property. The approach taken in appointing the advisers for the ADC sale process is not consistent with providing effective competition in order to achieve value for money.

Sale tender process

10. Overall, the tender process was well conducted and was completed on time. The Request For Tender specified the mandatory and other requirements; and tenders were evaluated against specified criteria during the evaluation.

11. As part of the decision to retain property, or to sell it under a leaseback arrangement, the total cost of the commitments under the lease, and the method for financing those lease payments should be assessed against the investment of the potential proceeds from sale. However, the Tender Evaluation Report for the ADC Weston Creek sale did not specifically address the issue of value for money to the Commonwealth.

12. Total rental payments due under the lease over the 20 year term amount to $59.9 million. ANAO calculated that a breakeven point will be reached during Year 14, after which the net cash outlay for rental payments will be $21.8 million. ANAO estimated that the sale transaction could result in a negative net present value (NPV) of $9.3 million, when the net sale proceeds are compared with the lease payments over the 20 year term.[2] The ANAO sought property and valuation advice from the AVO on the terms and conditions of the sale of the ADC Weston Creek property. The AVO considered that a breakeven point during Year 14 of this 20 year lease was within an acceptable range for an investment decision for freeing up capital.

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[2] This analysis does not include costs, other than lease payments, that the Commonwealth is responsible for under the terms and conditions of the lease. For example, maintenance and insurance costs.

Financial returns

13. The sale of the ADC property, and leaseback to the Commonwealth, provided an attractive investment opportunity for prospective purchasers. Strong interest was expressed in the transaction, with 11 of the 17 bids tendered exceeding the market valuation. The sale was conducted in a competitive manner and the contract was awarded to the highest priced conforming tender.

14. The sale realised proceeds of $31.7 million (including GST). The sale price exceeded the assessed fair market value prior to sale of $27 million (excluding GST). However, the sale proceeds were less than the Budget revenue estimate for the property ($45 million). The cost of sale was 2 per cent of the sale price, the major components being legal and technical advice.

Additional accommodation

15. Prior to the ADC Weston Creek property being put to the market, a need for additional accommodation on the site, including a new building and an extension to an existing building, had been identified within Defence. The additional facilities were proposed to accommodate an increase in both student numbers and demand for the use of the ADC's facilities, and to allow more efficient use of the educational facilities at the site. Immediately following the sale, Defence accepted a proposal for a consultant to provide a concept design of the additional accommodation requirements.

16. The sale and leaseback process was driven by the requirement to sell the property in the 2002–03 financial year, and to maximise the sale price. However, such objectives could be at odds with protecting the longer term interests of the Commonwealth in terms of providing for future development needs at the ADC Weston Creek site. In particular, the executed sale and lease documents do not adequately address the Commonwealth's identified future accommodation needs for the site over the 20 year term.

Overall conclusions

17. Overall, the ANAO found that Defence's management of the sale process was consistent with Government intentions. The sale realised proceeds in excess of the market valuation and was completed on time within the 2002–03 financial year. However, it is noted that the sale was not supported by a business case justifying selection of the property for sale and leaseback.

18. ANAO identified that the sale and long term leaseback arrangements for the property may not adequately protect the longer term interests of the Commonwealth in the site. The need for additional accommodation, identified prior to sale, was not resolved prior to finalising the sale. In order to meet the sale deadline and to maximise financial returns, Defence has assumed the risks associated with potential future development at the site.

Response to the report

19. The ANAO made five recommendations on the management of the property sale and long term leaseback process. Defence agreed to the five recommendations, two with qualification.

Recommendations

Set out below are ANAO's recommendations, with report paragraph references, and Defence's response. More detailed responses are shown in the body of the report.

Recommendation No.1
Para 2.12

ANAO *recommends* that Defence prepare a business case for all Defence properties identified for possible sale and leaseback, identifying whole of lease costs and any risks that may impact on protection of the Commonwealth's interests over the term of the lease.

Defence response: Agreed.

Recommendation No.2
Para 2.20

ANAO *recommends* that estimated revenue from the sale of Defence property, used in the Budget process as a target against which Defence will calculate proceeds to be retained by the Department, should be based on market valuations. Those market valuations should be current and reflect, as closely as possible, the terms and conditions on which the property will be presented to the market for sale.

Defence response: Agreed with qualification.

Recommendation No.3
Para 3.9

ANAO *recommends* that, to assist in maximising value for money in future contracting processes for advisers to property sales, Defence:

(a) wherever possible, conduct competitive selection processes for advisory contracts;

(b) develop an outsourcing strategy for each property sale or series of sales, including planning for a possible staged procurement approach to major advisory contracts; and

(c) prior to work commencing, sign written contracts with advisers, including indemnity and confidentiality provisions.

Defence response: Agreed, with qualification in respect of part (a).

Recommendation No.4
Para 3.28

ANAO *recommends* that Defence's approval processes for the sale and leaseback of property include an assessment of the value for money to the Commonwealth of the divestment decision, comparing the total cost of the commitments under the lease, and the method for financing those lease payments, against the investment of the potential proceeds from sale.

Defence response: Agreed.

Recommendation No.5
Para 4.35

ANAO *recommends* that, where a property is to be sold with a long term leaseback arrangement to the Commonwealth, plans for any future accommodation needs on the site over the term of the proposed lease, and the accompanying approval processes, be considered in the timing of the sale process and the terms and conditions of the contract and lease documents.

Defence response: Agreed.

Audit Findings and Conclusions

1. Introduction

This chapter provides an overview of proceeds from Defence property sales, the Australian Defence College (ADC) Weston Creek campus, and of the audit approach.

Background

1.1 The Department of Defence (Defence) operates one of the largest real estate portfolios in Australia, owning some 370 properties. The Defence Estate is valued at around $15 billion, consisting of approximately three million hectares of land with some 25 000 facilities.[3] The Defence Estate includes training areas, command headquarters, airfields, ship repair facilities, office and living accommodation, warehouses and explosive ordnance storehouses. The Defence Estate is managed by the Infrastructure Division, within the Corporate Services and Infrastructure Group of the Department.

1.2 Defence has been responsible for the management of its property estate, including the sale of property, since 1990. Defence advised ANAO in June 2004 that, since the Defence Efficiency Review, released by the Minister in April 1997, there had been 166 property sales (1997–2003), generating proceeds in the order of $1.06 billion.[4] Since 2000, some $571 million has been returned to consolidated Commonwealth revenue, the remainder of the proceeds being retained by the Department.

Proceeds from Defence property sales

1.3 During the period 1996–97 to 1999–2000, Defence was able to retain proceeds from asset sales up to a ceiling of 1 per cent of the Defence annual budget. As sale proceeds obtained during this period were below the threshold, no payments were required to be made to consolidated Commonwealth revenue.

1.4 From 2000–01, annual targets for sale proceeds were set through the Budget process. The Budget target figure was required to be returned to consolidated Commonwealth revenue. Any amount generated above the target figure could be retained by Defence. Figure 1.1 details target and actual proceeds from the sale of Defence property for the last three financial years.

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3 Defence website, Infrastructure Division.

4 Including proceeds from the sale of the office buildings (Defence Plazas) in Sydney and Melbourne managed by Finance.

Figure 1.1

Annual proceeds from sale of Defence properties: 2000–01 to 2002–03

Financial year	Budget target $m	Revised Budget target $m	Actual proceeds $m (GST exclusive)	Proceeds returned to consolidated Commonwealth revenue $m	Proceeds retained by Defence $m
2000–01	480.2	480.2	47.0	0	47.0
2001–02	633.5	71.7[1]	161.1	97.2	63.9
2002–03	659.5	473.5	578.0	473.5	potentially 104.5[2]

Note: (1) 2001–02 Budget target revised due to deferral of sale of properties to 2002–03.
(2) Defence advised ANAO in April 2004 that the Department of Finance and Administration had not yet agreed the proceeds to be retained by Defence.

Source: Budget Papers and Defence

1.5 A new incentive regime, to apply to proceeds from the future sale of Defence property, was being developed by the Department of Finance and Administration (Finance) in consultation with Defence for consideration in the 2003–04 Budget context.[5] However, Defence advised ANAO in April 2004 that the Government decided that the incentive arrangement that applied in 2002–03 would continue to apply in 2003–04, and that future incentive arrangements are subject to Government consideration. The Budget revenue target for proceeds from Defence property sales for 2003–04 is $199.9 million. The 2003–04 Budget Papers disclosed that Defence expects to retain $46.32 million in property sales proceeds each year between 2003–04 and 2006–07.[6]

1.6 Defence is pursuing a number of reforms for the management of the Defence Estate. In relation to disposal of property, Defence is reviewing the process for identifying properties for sale, models for the sale process, and incentive regimes. In April 2003, the Government directed Defence and Finance to review the Defence Estate to look for opportunities to rationalise the Estate and identify redundant property holdings. The Minister for Defence decided that, without a strategic review of the disposition (basing location) of the Australian Defence Force (ADF), based on operational and capability outcomes, a property review would reveal very little extra redundant property for disposal over and above that already programmed for sale as a consequence of the Defence Efficiency Review.

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5 Included in Government decision to proceed with Defence property sales for 2002–03.

6 Portfolio Budget Statements 2003–04 Defence Portfolio, Table 1.9.

1.7 Defence also saw the Estate review as an opportunity to undertake a fundamental examination of the ADF disposition in order to generate an affordable and sustainable Defence Estate in support of the future ADF, as detailed in the Defence Capability Plan. To progress this issue, and to comply with the Government direction, Defence undertook a Force Disposition/Defence Estate review. The project objective was to prepare a report to the Minister for Defence providing options to align ADF base locations with its capability requirements in order to achieve an effective and efficient force disposition. The project reported to the Minister in October 2003. Defence advised that it established a strategic framework providing Government with options to guide the attainment of optimal force disposition. At the time of the audit, the report was with the Minister for consideration.

ADC Weston Creek

1.8 Defence provides formal tri-service training through the Australian Defence College (ADC). A re-organised ADC[7] commenced operations on 1 January 2001. The ADC comprises three tri-service educational organisations. Two of these, the Centre for Defence and Strategic Studies (CDSS)[8] and the Australian Command and Staff College (ACSC)[9], are located at the Weston Creek campus in the ACT. The third tri-service educational organisation, the Australian Defence Force Academy, is located in Campbell ACT.

1.9 The ADC Weston Creek offers courses to members of the ADF and generates revenue from full fee paying overseas students. The campus comprises five main buildings. Three of the buildings were constructed in 1994. The Sheddon Building, housing the CDSS, was refurbished in 1999 and the Library and Gymnasium in 2001. The Geddes Building, housing the ACSC, and the Mess were constructed in 2000–01. Construction costs for the site over the period 1999–2000 to 2001–02 amounted to $26.2 million. The refurbishment provided for co-location of officer training for all Services at the one training college.

1.10 The ADC Weston Creek campus was disposed of in 2003 through a sale and leaseback transaction.

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7 The reorganisation of the ADC is part of the ongoing restructure of the Defence officer education continuum.

8 The CDSS was formerly known as the ADC.

9 The Defence Reform Program, which arose out of the Defence Efficiency Review, identified a need for greater efficiency in officer education. The creation of the ACSC provided for the co-location of the three Service staff colleges at Weston Creek. Single Service staff colleges were previously located at HMAS Penguin, Fort Queenscliff and RAAF Fairbairn.

Audit approach

1.11 This was the second property disposal via sale and long term leaseback managed by Defence.[10] The objective of the performance audit was to examine the efficiency and effectiveness of the management by Defence of the sale process for the ADC Weston Creek property. In particular, the audit:

- assessed the effectiveness of the management of the sale process, including the extent to which the Government's sale objectives have been achieved;
- examined the long term sale and leaseback arrangements for the property and assessed whether they adequately protect the Commonwealth's interests; and
- identified principles of sound administrative practice to facilitate improved administrative arrangements for future Defence property sales.

1.12 The audit examined the process of identifying the ADC Weston Creek property for sale and leaseback and the management of the sales process, within the 2002–03 Defence property disposals program. In this context, the long term lease entered into between the Commonwealth, represented by Defence, and the new owner, was examined to determine whether the transaction was in fact a sale and leaseback or a financing transaction. The financial implications are different and can impact the decision taken.

1.13 The Australian Government Solicitor (AGS) provided ANAO with legal advice in connection with aspects of the Commonwealth's rights and obligations under the lease. The Australian Valuation Office (AVO) provided ANAO with advice on property and value for money issues surrounding the transaction.

1.14 Audit fieldwork was conducted between September and November 2003. Fieldwork was conducted in Defence. Records maintained by external advisers to Defence for the sale and leaseback process were also examined. Issues Papers were provided to Defence in February 2004 with the Department responding in April 2004. A draft report was provided to Defence in May 2004. The audit was conducted in accordance with ANAO auditing standards at a cost to the ANAO of $199 000.

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10 The sale followed the sale and leaseback of Campbell Park, managed by Defence, and a number of sale and leaseback transactions of commercial offices from the Defence Estate managed by Finance.

2. Divestment Decision Process

This chapter examines the policy framework for disposal of property, the basis for the sale and leaseback of the ADC Weston Creek campus, and the 2002–03 Defence property disposals program.

Policy for divestment

2.1 The policy framework for the divestment of Commonwealth real property provides for the sale of property identified as surplus to Commonwealth needs, or where the property does not achieve a set rate of return. The 1986 Commonwealth Property Disposals Policy provides for property with no alternative efficient use to be sold on the open market. Exceptions to that policy include priority and concessional sales.[11]

2.2 Government policy on the ownership of property is more recently contained in the Commonwealth Property Principles (CPPs), endorsed by the Government in July 1996 and amended in May 2002. The CPPs apply to all Commonwealth property and are administered by Finance. The CPPs set the framework within which the Government will take decisions on the need to retain or dispose of property. They are based on the premise that the Commonwealth should own property only where rates of return on property exceed a set hurdle rate or where it is in the public interest to do so. In May 2002, the CPPs were updated and the hurdle rate, against which properties should be assessed in determining whether a property should remain in Commonwealth ownership, was decreased from 14–15 per cent, set in 1996, to 11 per cent.

Defence policy framework

2.3 Properties are sold from the Defence Estate where they have been identified as surplus to Defence needs and not meeting the Government's criteria for retention. Defence applies the term 'surplus' to property not required for Defence capability.

2.4 At the time of the ADC Weston Creek sale, the *Defence Estate Management Guide* addressed the divestment of Defence property.[12] The guide

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[11] Priority sales are those made direct to a purchaser without the property having first been offered for sale on the open market. The policy sets out the circumstances in which such a sale can be arranged. Priority sales require the approval of the Minister for Finance and Administration or, in certain cases, the Minister's delegate. Concessional sales are priority sales concluded at a price below market value and require the approval of the Minister for Finance and Administration. In the case of Commonwealth statutory authorities, the agreement of the relevant portfolio Minister is also required.

[12] Subsequent to the sale of the ADC property, the *Defence Estate Management Guide* has been replaced by the *Infrastructure Manual*.

included a *Disposal of Defence Property Policy Framework* published in July 2001. The framework referred to:

- the *Strategic Plan for the Defence Estate 1999* (SPDE), which identified property that should be divested based on Defence's strategic estate needs;
- the programming of property identified for divestment in the Estate Development Plan; and
- a requirement for the production of a business case for divestment in the form of a disposal strategy, and a post disposals report for individual property sales.

2.5 The SPDE was developed as a planning document and endorsed by the Defence Executive in December 1998. The SPDE provided a link between Defence Estate strategic planning and overall Defence strategic policy, and identified property that should be divested from the Defence Estate. Contribution to capability was identified as a key criterion for the rationalisation and consolidation of the Defence Estate.

2.6 The SPDE report classified property into three categories. Category 3 properties were identified for disposal within five years. Category 2 properties were identified for possible disposal in the medium to long term, within 10 years. Category 1 properties were identified for retention for 30 years.

2.7 The report noted that three single Service staff college facilities would become excess to requirements in 2001 following co-location of the Colleges at the Weston Creek site. The Weston Creek property, noted to be established as the new ADC, was classified in the 1999 SPDE for retention for 30 years. However, Defence subsequently moved away from this earlier strategic document.

Business case for sale

2.8 In November 2001, the firm later to be engaged as the sales adviser for the sale of the ADC Weston Creek property, responded to a request from Defence to provide a financial analysis for the sale and leaseback of three Defence properties. The firm was tasked to determine whether there was a sound business case to support sale and leaseback proposals for those properties, which included the ADC Weston Creek. The draft report of 5 February 2002 stated that the long term requirement for the property, and the financial analysis performed by the firm, did not support the sale and leaseback proposition because the payback period for the property was considerably less than the industry benchmark.[13] A final version of the report was not included in Defence records.

2.9 In 2002, Defence engaged a firm to undertake business case analyses of the divestment strategies for 36 of the Defence properties identified for divestment in 2002–03. The firm reviewed the business plans for the development and divestment of the properties and assessed the net proceeds expected to be realised if the properties were sold in their current state, and if investment was made on the properties prior to sale. The July 2002 review report identified 16 properties where sale proceeds could be enhanced through capital investment prior to sale, and 20 properties for which Defence strategies were considered appropriate.

2.10 The report noted that the ADC Weston Creek property was not included in this later review of properties, as no information was available for the firm to review. Defence and Finance reviewed the recommendations included in the report. A disposal strategy, which included the ADC Weston Creek property, was endorsed by the Minister for Finance and Administration and the Minister for Defence.

2.11 The *Defence Estate Management Guide* required the divestment of property to be supported by a business case. Any issues that arise during a sale and leaseback process, that could impact on that business case, should be considered in the decision to proceed with the divestment of the property. ANAO was unable to identify from Defence records any business case analysis to support a proposal to dispose of the ADC Weston Creek property from the Defence Estate through a sale and leaseback transaction.[14] ANAO notes that the Government approved the sale and leaseback of the ADC Weston Creek through the Budget process for 2001–02, subject to Defence seeking advice from Finance as to whether the proposed sales were consistent with the CPPs. ANAO has not sighted evidence that the property was assessed against the criteria of the CPPs. The sale was approved by the Government through the Budget process as one of the Defence Estate properties to be sold during 2002–03 and a disposal strategy was subsequently developed for the sale process.

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[13] The analysis was based on lease terms different from those that were eventually put to the market. In this analysis, an estimated net rent of $160 per square metre was applied. The draft report states that Defence had expressed a long term requirement for the property of up to 50 years. However, the analysis was based on an initial lease term of 20 years. A sale price of $15.8 million was calculated by capitalising an indicative net market annual rent by the yield. The analysis applied an indicative yield rate of 9 per cent. The firm therefore considered that the target sale price at that time of $45 million was considerably above market. The basis for the target price was not specified.

[14] The report of the Tender Evaluation Board for the sale and leaseback of the property, recommending the preferred tenderer to the Delegate, noted that the ADC site at Weston Creek was declared surplus to Defence requirements in 2002. ANAO did not identify documentation to support the classification of the property as surplus.

Recommendation No.1

2.12 ANAO *recommends* that Defence prepare a business case for all Defence properties identified for possible sale and leaseback, identifying whole of lease costs and any risks that may impact on protection of the Commonwealth's interests over the term of the lease.

Defence response

2.13 Agreed.

2002–03 Defence property sales

2.14 In the 2002–03 Budget, 41 Defence properties were approved for sale, with a total revenue target of $659.5 million. This included the sale of the ADC Weston Creek, with an estimated revenue target of $45 million. Proceeds from the property sales, up to the estimated revenue figure, were to be paid into consolidated Commonwealth revenue. Any proceeds in excess of the target could be retained by Defence. As the sale of Russell Offices in Canberra was to be managed by Finance, the Budget revenue target[15] above which Defence was able to retain proceeds, was $473.5 million.[16]

2.15 Progress against this target was monitored by an Inter-Departmental Committee (IDC), established to oversee the 2002–03 Defence property sales program. The IDC comprised Defence, Finance, the Department of the Treasury (Treasury) and the Department of the Prime Minister and Cabinet. The IDC was required to provide quarterly reports on the progress of the sales program to the Prime Minister. Attention was focussed on properties for which there was a risk of not completing the sale in 2002–03, or of not achieving the initial budget estimate for sale proceeds. The ADC Weston Creek property was identified as being at risk of not achieving the estimated revenue from sale.[17] A list of alternative surplus Defence properties for sale during the year was identified to ensure that the Budget estimate would be achieved.

Revenue outcome

2.16 The property sales were to be completed within 13 months of the Budget process for which the estimates were prepared. Market valuations are

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[15] Defence advised ANAO in April 2004 that 'the matter of GST, whether the target is GST inclusive or exclusive, was not raised when the target was set in the context of the 2002–03 Budget'.

[16] The Russell Offices property was included in the list of Defence properties to be sold, with an estimated revenue target of $186 million. This property was withdrawn from the market in April 2003.

[17] Proceeds to be generated from sale of the property were estimated at $45 million in 2001–02 and this estimate was included in the Budget target for 2002–03. Defence records refer to $45 million as the estimated replacement value of the property.

prepared prior to the property being put to the market and are based on the terms and conditions on which the property is to be presented to the market.

2.17 Defence was successful in achieving proceeds above the total of the market valuations for the properties sold, and exceeded the Budget target for sale proceeds in 2002–03 by $104.5 million.[18] Defence advised ANAO in April 2004 that the Budget revenue target of $473.5 million was returned to Finance during 2002–03 and that Finance had not yet agreed the proceeds to be retained by Defence in 2002–03.[19]

2.18 Figure 2.1 details the 41 properties approved for sale in the 2002–03 Budget. Of those:

- one was sold in 2001–02;
- 23 were sold in 2002–03;
- five sales were incomplete as at 30 June 2003;
- nine sales were deferred to 2003–04, and one sale to 2004-05; and
- two sales were withdrawn.[20]

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18 Total receipts for 2002–03, exclusive of GST, were $578 million resulting from sale of properties from the 2002–03 sales program of $543.4 million, 11 additional properties approved for sale in 2002–03 of $26.2 million and, as advised by Defence, a further $8.4 million from proceeds outside the disposals program.

19 Defence advised ANAO that 'in reconciling the 2002–03 outcome, [*Finance*] raised some minor issues in relation to Defence's authority to retain specific sale proceeds. These issues will be resolved via the normal budget development process in conjunction with the Department of Finance'.

20 Monthly report to IDC titled 'Property Disposal Report 2002–03, June 2003', in draft at time of audit.

Figure 2.1

2002–03 Defence Property Sales Program ($million)

41 PROPERTIES APPROVED FOR SALE IN 2002–03 BUDGET						
	Budget revenue estimate	Valuation (GST exclusive)	Sale proceeds 2002–03 (GST inclusive)		Budget revenue estimate	Valuation 2002–03
Sold 2002–03				**Not sold 2002–03**		
ADC Weston Creek	45.0	29.5[1]	31.7	**Sold 2001–02**		
Training Depot Albury	1.2	1.5	1.6[2]	Dundas	9.2	
Lady Gowrie House Bondi	5.7	6.8	11.8	**Sale incomplete 2002–03**		
Training Depot Coffs Harbour (part sale)	0.1	0.3	0.3	Haberfield[5]	12.0	17.6
Endeavour Hostel Coogee	26.0	34.0	77.8	Broadmeadows	3.2	4.2
Training Depot Cootamundra	0.1	0.0	0.1	Building 72 Maribyrnong	3.6	3.8
Stores Depot Dubbo	4.0	0.1	4.7	Portsea	15.0	34.0
Training Camp Gan Gan	1.7	1.8	2.4	Logistics Facility Winnellie[6]	4.0	3.0
Kokoda Holsworthy	13.6	12.7	20.1	**Sale deferred to 2003–04**		
DNSDC Moorebank	105.0	145-163	209.1	Transmitting Station Gungahlin	0.2	0.1
REVY Pyrmont	40.0	32.0	26.3[3]	Amiens Moorebank	6.5	8.3
Randwick (Stage 1A)	28.0	25.9	56.2	Training Depot Bathurst	0.2	0.5
Regents Park	32.0	33.0	40.9	Stores Depot Bogan Gate[7]	0.7	0.6
Yulong, Moorebank	3.0	36.3	40.9	Ermington	17.3	
Rockbank	6.8	5.8	6.8[4]	Thornton Park Penrith	22.0	22.0
Somerton	4.0	8.0	17.6	Rifle range Stockton	0.7	0.7
Communications Station Acacia Ridge	0.5	1.5	4.0	Werrington Kingswood	4.0	6.8
Stores Depot Banyo	7.9	10.0	15.1	Logistics Base Meeandah	15.0	15.8
Dalrymple Road Townsville	0.6	2.0	5.2	**Sale deferred to 2004–05**		
Mann Street Cairns	1.8	2.1	3.0	Schofields[8]	25.5	25.5
Smithfield	2.6	1.5	2.5	**Withdrawn from market**		
Army Barracks Brighton	0.3	0.2	0.2	Russell Offices	186.0	
Edinburgh (part sale)	2.0	1.3	2.4	Communications Centre Caversham	2.5	
Total	**331.9**	**391.3–409.3**	**580.7[9]**	**Total Budget revenue target for 41 properties**	**659.5**	

Notes: (1) The ADC Weston Creek property was re-valued at $27 million during the due diligence process.
(2) Property sold on 30 June 2003 for $1.8 million, $0.2 million received in 2003–04.
(3) Property sold for $29 million, $2.7 million received in 2003–04.
(4) Property sold for $8.5 million, $1.7 million received in 2001–02.
(5) Contract exchanged, $18.2 million to be paid in 2003–04.
(6) Contract exchanged, $3.7 million to be paid in 2003–04.
(7) $0.2 million received in 2002–03 for part sale of property.
(8) $3.7 million received in 2002–03 for part sale of property, remainder of property subject to rezoning.
(9) Sale proceeds for 2002–03, from properties approved for sale in the 2002–03 Budget, totalled $589 million, including proceeds to be received in 2003–04 ($2.9 million, Notes 2 and 3), proceeds received in 2001–02 ($1.7 million, Note 4) and receipts from part sale of properties deferred for sale in subsequent years ($3.9 million, Notes 7 and 8).

Source: Monthly report to IDC *Property Disposal Report 2002–03, June 2003* in draft at time of audit, valuation figures updated by Defence subsequent to issue of IDC report.

2.19 The outcomes detailed in Figure 2.1 highlight the need for revenue estimates, used as a basis for calculating the amount of proceeds Defence should be permitted to retain, to be appropriately based and rigorously derived. For a number of properties, a low Budget revenue estimate compared to the properties' market valuations resulted in Defence potentially securing a significant windfall gain in funding. In particular, ANAO notes that:

- a number of the Budget revenue estimates for individual properties did not provide an accurate reflection of the value of the property. With the exception of the ADC Weston Creek, these estimates significantly understated the value of the property. For example, AVO valued the Yulong property at more than 1 100 per cent of the Budget revenue estimate; and the valuation of the DNSDC Moorebank property was more than 47 per cent higher ($49 million) than the Budget revenue estimate[21];
- sale proceeds for a small number of properties, but representing 68 per cent of total proceeds, significantly exceeded both the valuations and the Budget revenue estimates (see Figure 2.2); and
- Defence advised ANAO in April 2004 that the Sydney market was particularly buoyant in 2002–03.

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21 Based on the mid-point of the assessed range of the valuation.

Figure 2.2

Analysis of selected 2002–03 Defence Property Sales

Property	Sale proceeds ($m)	Excess over Valuation		Excess over Budget Revenue Estimate	
		$m	%	$m	%
DNSDC Moorebank	209.1	55.1	36[1]	104.1	99
Endeavour Hostel Coogee	77.8	43.8	129	51.8	199
Randwick (Stage 1A)	56.2	30.3	117	28.2	101
Yulong, Moorebank	40.9	4.6	13	37.9	1263
Somerton	17.6	9.6	120	13.6	340

Note (1) Based on the mid-point of the assessed range of the valuation.

Source: ANAO analysis, Defence and draft Monthly report to IDC 'Property Disposal Report 2002–03, June 2003'

Recommendation No.2

2.20 ANAO *recommends* that estimated revenue from the sale of Defence property, used in the Budget process as a target against which Defence will calculate proceeds to be retained by the Department, should be based on market valuations. Those market valuations should be current and reflect, as closely as possible, the terms and conditions on which the property will be presented to the market for sale.

Defence response

2.21 Defence agreed to the recommendation with qualification. Defence's detailed response to the recommendation was as follows.

> Property valuations have a limited life and the state of the market on the day will determine the final value of a property, reflected as the paid price. The Government agreed arrangements for property sales in 2004-05 includes a requirement for Defence to re-value properties for disposal prior to the final target being agreed.

3. Divestment Management

This chapter examines the management of the sale and leaseback process for the ADC Weston Creek property.

Introduction

3.1 Defence is responsible for the management of its own properties, which represent a high proportion of the overall Commonwealth Estate. Due to its experience in conducting property sale and leaseback transactions, Finance is generally responsible for conducting divestments, using this method, across the entire Commonwealth Estate, including for Defence properties. However, Defence assumed responsibility for the sale and leaseback of Campbell Park Offices and the ADC Weston Creek property in Canberra.

Engagement of advisers

3.2 An internal Defence Minute seeking approval of the establishment of the core project team to manage the sale and leaseback process of the ADC Weston Creek property was prepared within Defence in August 2002. The estimated project cost was based on services to be provided by external advisers. A preliminary project plan was included, with a planned settlement date of May/June 2003. Approval of this proposal for the core project team and project plan was not held in Defence records of the sale process.

3.3 Defence engaged a number of external advisers to assist in the sale and leaseback of the ADC, including the following:

- technical adviser, to manage the due diligence process, including the selection of sub-contractors;
- commercial sales adviser, to assist with the development of the lease and preparing the property for market;
- legal adviser;
- probity adviser;
- financial adviser, to provide accounting advice on the form of the lease and taxation issues; and
- sales agent, to manage the marketing of the property.

3.4 The Commonwealth Procurement Guidelines provide for competitive procurement processes where competition will produce a commensurate benefit. A competitive tender process was followed for the engagement of only one of the advisers.[22] Direct engagement of the other advisers was based on those advisers' earlier performance in the previous sale and leaseback of the Campbell Park property, managed by Defence.

3.5 ANAO noted that the engagement of advisers in the Campbell Park sale process was also on a non-competitive basis. In that sale, direct engagement was approved to facilitate the completion of the sale in a tight timeframe and on the basis of assistance previously provided to Defence by those advisers and/or inclusion on Defence panels. It was not identified, during the engagement process in the Campbell Park property sale, that those advisers would again be appointed for the following sale of the ADC Weston Creek property. The approach taken in appointing the advisers for the ADC sale process is not consistent with providing effective competition in order to achieve value for money.

3.6 The nature of the services to be provided by consultants to the Commonwealth and the basis for payment should be included in a contract or letter of engagement with each consultant. Contracts, or letters of engagement, were completed with the major advisers to the ADC sale, with the exception of the probity adviser and the technical adviser. While there was reference to Defence approval for the engagement of the sub-contractors recommended by the technical adviser, records of the approval do not exist.[23] As well, short form contracts with those sub-contractors providing due diligence services were not held by Defence.[24]

3.7 Defence sought lump sum fee proposals from the key advisers. The sales adviser offered services on an hourly fee basis. The contract exchanged in February 2003, some time after the firm began participating as a member of the sales team, was based on hourly fees.

3.8 A lump sum quote for services was sought from both the legal and probity advisers. The payments to those advisers exceeded the initially approved lump sums, on the basis of work performed outside the scope of services on which the lump sum was based, as follows:

- the probity adviser's proposed lump sum offer was $11 000 with work falling outside scope to be charged at panel rates. Amendments to the

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22 In both property sale processes, the sales agent was appointed from a select tender process in which four firms were invited to submit proposals.

23 The exception to this was Defence approval sighted for the engagement of a sub-contractor to provide a survey brief.

24 With the exception of the confidentiality agreement signed by the probity adviser, contractor confidentiality agreements were not dated. Defence records indicate that they were not provided to Defence until mid-March 2003, five months after the sale project commenced. The probity plan required that all project team members listed in that plan sign a Confidentiality and Conflict of Interest Undertaking within 10 days of the approval of the plan or the date they became a team member.

purchase order for services totalling $42 000 were approved by Defence; and

- the approved fee arrangement with the legal adviser was for the lesser of charged time or a capped fee of $65 000. An amendment to the purchase order for services for an additional $80 000 was approved by Defence to cover issues beyond the agreed scope of works.

Recommendation No.3

3.9 ANAO *recommends* that, to assist in maximising value for money in future contracting processes for advisers to property sales, Defence:

(a) wherever possible, conduct competitive selection processes for advisory contracts;

(b) develop an outsourcing strategy for each property sale or series of sales, including planning for a possible staged procurement approach to major advisory contracts; and

(c) prior to work commencing, sign written contracts with advisers, including indemnity and confidentiality provisions.

Defence response

3.10 Defence agreed to the recommendation, with qualification in respect of part (a). Defence's detailed response to the recommendation was as follows.

> In regard to recommendation 3(a), Defence believes that the best team available was engaged to provide the technical, legal and probity advice needed to manage the sale and leaseback of the ADC. As noted in the report, external advisers (other than the sales agent) were engaged on the basis of their experience in a very similar sale arrangement, the sale and leaseback of Campbell Park. Given that experience, Defence does not believe that implementing a more competitive process would have delivered a better value for money outcome given the resources required to complete such a process. This is reflected in the price obtained for the property (which was above valuation).
>
> Additionally, Defence has in place various panel arrangements, effectively standing offer contracts, for various services, including legal services. Legal and probity advisers engaged for the sale and leaseback of ADC were on the Legal Panel. The Panel arrangement pre-qualifies consulting firms. The aim of such arrangements is to improve procurement outcomes, and delivers a consistent standard of professional support whilst growing a mutually beneficial collaboration for both industry and Defence.

Sale preparation

3.11 The sale preparation process identified some risk to achieving the target Budget revenue proceeds from sale. Market valuations of the ADC property were sought from the AVO as at 30 June 2002 and prior to sale. The 30 June 2002 assessment of $29.5 million was based on lease terms and conditions similar to those put to the market in the sale process. However, a later survey of the property identified a discrepancy in the calculation of net lettable area (NLA), affecting the annual rental figure and the valuation.

3.12 In January 2003, an updated valuation was sought. Defence advised the AVO that it was endeavouring to incorporate development rights for Defence into the sale and leaseback documentation, but that it did not consider there to be much value in trying to value that element of the project. The revised fair market valuation of $27 million, as at 1 January 2003, was based on a NLA of 9 286 square metres and a 20 year lease with a nine year extension option.[25]

3.13 Due diligence material prepared for the ADC Weston Creek property was well received by the prospective purchasers of the property. There was a low incidence of non-conforming tenders and only one tender was lodged subject to additional due diligence.

Tender process

3.14 The property was advertised for sale with a 20 year lease and an option for the Commonwealth to extend for a further 10 year period. The initial rent of $2.2 million per annum was market based and the lease provides for a fixed annual 3 per cent increase. The sale and leaseback of the ADC property was completed in the 2002–03 financial year. Figure 3.1 outlines the timing of the process.

[25] Defence sought advice from the AVO in February 2003 on the impact of an increase to the Gross Floor Area (GFA) in the Crown Lease, to provide for the construction of additional facilities, on the value of the property. The AVO considered that the market value would not be enhanced, based on the estimated revised overall rental rate for the property and the estimated cost of construction.

Figure 3.1

Chronology for the sale and leaseback process

Task	Date
Advertising commenced	5 March 2003
Tender Evaluation Plan approved	28 March 2003
Addenda Issued	24 March, 4 and 9 April 2003
Tenders closed	11 April 2003
Tender Evaluation Board convened	28 April and 1 May 2003
Tender Evaluation Report	2 May 2003
Legal and Probity Sign-offs	2 May 2003
Lands Acquisition Act 1989 Approvals	2 May 2003
Exchange of Contracts	2 May 2003
Settlement	12 June 2003
Lease Commencement	13 June 2003

Source: ANAO analysis of Defence records

3.15 The tender process was well conducted, as the following demonstrates:

- the Tender Evaluation Plan (TEP) was approved prior to release of the sale documents, and external advisers with specialised skills were engaged;
- probity and legal advice was sought by Defence throughout the process and sign-offs were obtained covering their involvement in the process;
- the process was effectively managed through a Project Control Group (PCG);
- available documentation indicated that consistent information was provided to all prospective purchasers;
- mandatory and other requirements were specified in the Request for Tender (RFT) and tenders were evaluated against those criteria during the evaluation stage of the tender process; and
- there was a low incidence of non-compliance in tenders lodged.

3.16 The RFT required full compliance with mandatory requirements and provided Defence with discretion to accept or reject non-compliance against other requirements. Mandatory criteria related to the terms of the lease, requiring terms to be consistent with an operating lease and not a finance lease. The other criteria were high price, low legal and financial risk and the degree of compliance with the Other Requirements.[26] The TEP required a qualitative evaluation based on value for money, reflecting the highest price offered for the assessed least risk.

3.17 The legal adviser certified on 2 May 2003 that the Contract for Sale was upon the terms and conditions approved by Defence, adequately protected the interests of the Commonwealth, and was in order for execution. On 30 May 2003, the legal adviser further certified that the Crown Lease and Sublease for the property were upon the terms and conditions approved by Defence, adequately protect the interests of the Commonwealth and were in order for execution. The certification letter indicated that the Contract for Sale had been exchanged.

Probity

3.18 Documentation of the tender process could have been improved by maintaining records of all PCG meetings.[27] The PCG meetings were the forum that brought together the project team, including the external advisers. Records of deliberations and/or decisions taken at those meetings provide transparency of the tender process.

3.19 Documentation of communication with prospective purchasers could also have been improved by maintaining a log of all contacts and by registering all clarification questions raised. The RFT required that all enquiries by tenderers be in writing to the nominated contact person. The RFT stated further that the contact person was the only person with authority to initiate a response to the enquiry on behalf of Defence. The sale agent was listed as the contact person. A file review of documents held by the sale agent indicated that the requirement for a single point of contact was observed. A review of sale agent and adviser files indicated that questions documented were consistently passed from the sale agent to the relevant adviser, and back to prospective purchasers through the sale agent.

3.20 However, evidence of the completeness of those records, and the provision of consistent information to all prospective purchasers, could have been improved by registering all questions raised, and by cross-referencing responses to individual enquiries to information released to all interested parties prior to the tender closing date. The TEP required that all communication with tenderers be fully documented during the evaluation

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[26] Other Requirements were defined in the TEP as all Tender Conditions and the terms and conditions set out in the Contract and the Sublease other than the Mandatory Requirements.

[27] Defence did not maintain records of PCG meetings held after the meeting of 14 January 2003.

process. Again, no log of contacts with tenderers was maintained after the tender closing date.

3.21 The probity adviser to the sale process provided Defence with a probity sign-off dated 2 May 2003. The sign-off certified that the report of the Tender Evaluation Board had been prepared in accordance with the provisions of the TEP and the Probity Plan. The probity adviser reported that the tendering and evaluation processes had been conducted fairly and in accordance with the RFT, TEP and probity advice.

Sale approval

3.22 In effect, the approver of a Commonwealth property sale and leaseback endorses both the sale of the property and the execution of the lease for the property with the proposed purchaser. The disposal of property is approved under the *Lands Acquisition Act 1989*. The Minister for Finance and Administration or his delegate must provide final Commonwealth approval on the disposal of property assets.

3.23 The tender evaluation report recommended approval of the preferred tenderer but did not specifically address the issue of value for money in selling the property. In particular, a discounted net present value (NPV) calculation was not undertaken prior to approval of the property for sale and leaseback, to assess whether the transaction represented value for money to the Commonwealth. Whole of life costs for the sale and leaseback transaction were not included in the tender evaluation report, nor was a calculation of the yield.[28]

3.24 On 24 June 2003, subsequent to the sale of the property, the accounting adviser provided Defence with yield calculations for the property. An actual yield of 7.7 per cent was calculated, based on the sale price. ANAO notes that this figure did not take account of whole of lease costs. The accounting adviser informed ANAO in May 2004 that:

> the advice issued to the Department of Defence constituted an email with general calculations illustrating the principles of a yield calculation rather than formal advice. It also indicated that this calculation had not taken into account allowances for fit-outs or other incentives. Our advice also indicated that we would have to assess the nature of the transaction in further detail if a more specific calculation was required.

3.25 In the decision to retain property or to sell it under a leaseback arrangement, the total cost of commitments under the lease, and the method for financing those lease payments, should be assessed against the investment

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28 The yield is the financial return from the property, calculated using lease payments over the term of the lease.

of the potential proceeds from sale. Analysis undertaken by ANAO indicates that a breakeven point could be reached before the end of the lease term, after which the Commonwealth could be paying more for the leaseback arrangement than it could gain from investment of the sale proceeds. The analysis assumes that the proceeds from sale are invested for the term of the lease at the Treasury bond rate at the date of sale, and that the Commonwealth has borrowed funds to satisfy the annual lease commitments.[29]

3.26 Total rental payments due under the lease over the 20 year term amount to $59.9 million. ANAO calculated a breakeven point during Year 14, after which the net cash outlay[30] for rental payments would be $21.8 million. ANAO estimated that the sale transaction could result in a negative NPV of $9.3 million when the net sale proceeds are compared with the lease payments over the 20 year term. The lease commitments include the cost of funding the monthly payments in advance.[31] This analysis does not include costs, other than lease payments, that the Commonwealth is responsible for under the terms and conditions of the lease. For example, maintenance and insurance costs.

3.27 The ANAO sought property and valuation advice from the AVO on the terms and conditions of the sale of the ADC Weston Creek property. The AVO considered that a breakeven point during Year 14 of the 20 year lease was within an acceptable range for an investment decision to sell. The AVO advised:

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

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29 Lease payments are due monthly in advance under the terms of the lease.

30 Net cash outlay is the sum of annual rental commitments under the lease from Year 15 to Year 20, excluding funding costs.

31 ANAO analysis assumes:

- sale proceeds net of GST and cost of sale;
- lease term of 20 years with annual increments in lease payments of 3 per cent;
- discount rate based on Commonwealth 10 Year Treasury bond rate of 4.87 per cent at time of sale; and
- rental finance rate based on 30 day Treasury Note rate of 4.81 per cent at time of sale.

Recommendation No.4

3.28 ANAO *recommends* that Defence's approval processes for the sale and leaseback of property include an assessment of the value for money to the Commonwealth of the divestment decision, comparing the total cost of the commitments under the lease, and the method for financing those lease payments, against the investment of the potential proceeds from sale.

Defence response

3.29 Agreed.

4. Sale and Leaseback Outcomes

This chapter assesses the outcome of the sale and leaseback process for the ADC Weston Creek.

Financial returns

4.1 The sale of the ADC property, and leaseback to the Commonwealth, provided an attractive investment opportunity for prospective purchasers. Marketability of the property was achieved through the long term double net lease which secured a 20 year escalating cash flow from a Commonwealth tenant. As a financial investment it offered:

- an income stream underwritten by the Commonwealth via a long term lease of 20 years, with an Commonwealth option to extend for a further 10 years;
- guaranteed rental growth of 3 per cent per annum, with a review to market if the option period is to be exercised;
- tenant responsibility for operating expenses, including statutory charges and the Lessor's insurance and costs for management of the building services plant and equipment, and for service charges; and
- tenant responsibility for repair of building services, plant and equipment and civil works.

4.2 The sale was conducted in a competitive manner and strong interest was expressed in the sale and leaseback of the property. Of the 17 bids received, 11 exceeded the market valuation for the property.[32] Three bids were rejected for failure to meet mandatory requirements, and a further nine were rejected for posing medium to high financial and/or legal risk or for non-conformance.

4.3 Five tenders were assessed with relatively low financial and legal risk and as financially competitive. The contract was awarded to the highest bid in this group of tenders.[33] The financial capacity of the purchaser was reviewed prior to selection as preferred tenderer.

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[32] One tender was lodged after the tender closing time but prior to the tender box being opened. Defence accepted the probity adviser's recommendation that the tender be admitted to evaluation.

[33] The highest bid was rejected on the basis of non-conformance and failure by the tenderer to respond to requests for clarification. The second highest bid was rejected for failure to comply with mandatory requirements in the RFT, requiring changes to the lease terms that were likely to result in classification as a finance lease.

4.4 A Contract for Sale was exchanged on 2 May 2003 and a 20 year lease for the property commenced between the Commonwealth, represented by Defence, and the new owner on 13 June 2003. Defence is supplemented for the annual lease payments for the property.

4.5 The sale realised proceeds of $31.7 million (including GST) and was completed on time within the 2002–03 financial year. The sale price exceeded the fair market value assessed prior to sale of $27 million (excluding GST). However, the proceeds were less than the Budget revenue estimate.[34]

4.6 The Minute seeking approval for the establishment of the core team to manage the sale and leaseback, included an estimated project cost of $700 000 to $800 000, representing approximately 3 per cent of the market value for the property. The major components of the costs were legal advice and technical advice. The actual cost of sales reported by Defence was 2 per cent of the sale price.

Lease classification

4.7 Two leases were executed with the new owner of the ADC Weston Creek site and the Commonwealth of Australia. A Crown Lease for the land was executed for a term of 99 years.[35] A further lease for the 'whole of the Land and the Building' (the Lease) was executed for an initial term of 20 years. The Lease was developed by Defence, based on the lease executed for the Campbell Park property in 2002.

4.8 The RFT for the purchase of the ADC Weston Creek property included a mandatory requirement that the Lease be capable of classification as an operating lease, and not a finance lease, under Australian Accounting Standard 17 (AAS 17).[36] Two of the tenders submitted for the property were rejected for non-compliance with this mandatory requirement. Those tenders sought changes to lease terms and conditions that would not allow classification of the Lease as an operating lease.

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[34] The basis for the figure used for budgeting purposes could not be established by the ANAO.

[35] The property is used by Defence as an educational facility in accordance with the Crown Lease. The Crown Lease limits the purposes for which the land can be used. It provides that the premises can be used for the purposes of a defence installation, an education establishment and any purposes ancillary thereto, including a financial establishment. These uses are consistent with the zoning for the land, under the National Capital Plan, as B10 Broadacre Land Use. Included in current approved land use are educational or scientific research establishment, recreational facility, community centre, agricultural facility and Defence installation. B10 Broadacre Land Use does not include commercial office use, but does include special care establishment or hostel, and animal care, health or tourist facility.

[36] AAS17 defines an operating lease as 'a lease under which the lessor effectively retains substantially all the risks and benefits incident to ownership'. AAS 17 defines a finance lease as 'a lease under which the lessor effectively transfers to the lessee substantially all the risks and benefits incident to ownership of the leased asset and where legal ownership may or may not eventually be transferred'.

4.9 AAS 17 requires that a lease resulting from a sale and leaseback transaction must be classified either as a finance lease or an operating lease, as at the inception of the lease. Classification of the lease impacts on the accounting treatment of the transaction and related decisions.

4.10 Defence engaged a firm in February 2003 to provide accounting and taxation advice in relation to the sale and leaseback of the property. The firm was required to provide advice on whether the draft lease was an operating or finance lease. The firm was advised that 'the classification of the lease has important implications that may affect the achievement of the project and its overall objective'. Draft advice was provided in February 2003 and on 30 April 2003 Defence requested final advice. On 5 May 2003 the firm provided its advice, dated 18 February 2003, concluding that the leases over the land and buildings would be properly classified as operating leases.

4.11 On 21 July 2003, the Accounting Policy and Practices Branch of Defence provided an updated opinion on the lease classification, following settlement and based on the executed Lease.[37] Defence considered that the majority of risks and benefits incident to ownership appeared to rest with the Lessor. Defence therefore determined that, over the initial lease of 20 years, the lease appeared on balance to be an operating lease. Defence further considered that exercising the option to extend the lease for a further 10 years may result in re-classification of the improvements as a finance lease, and that the lease classification would need to be re-examined in the event that alterations were made to the property or the rent payable was altered. The ANAO examined the opinions of Defence and the external adviser to Defence.

4.12 AAS 17 provides for a lease involving both land and buildings to be treated as a unit for the purpose of lease classification where the lease does not provide for ultimate transfer of ownership to the lessee, and where the fair value of the land is considered immaterial in relation to that of the total property. The market valuation of the land, assessed by the AVO prior to sale, represented 13 per cent of the total value of the property, therefore requiring separate classification.

4.13 In accordance with AAS 17, as the title to the land does not pass to the Commonwealth at the end of the term of the Lease for 'the whole of the land and the building', the ANAO has assessed that the lease of land should be classified as an operating lease. This is consistent with the approach taken by Defence.

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[37] The advice provided by the accounting adviser to the ADC Weston Creek sale and leaseback process was considered in the formulation of this opinion by Defence.

4.14 In the assessment of the lease of buildings, the ANAO concluded that, on an economic substance basis, and on the outcome of the presumptive tests included in AAS 17, the lease should be classified as a finance lease. This is not, however, the approach taken by Defence. Detail of the lease assessment by the ANAO against the requirements of AAS 17 is included at Appendix 1 of this report. ANAO's 2002–03 financial statement audit also disagreed with Defence's classification but the issue did not warrant audit qualification due to materiality considerations.

4.15 In May 2004, the firm engaged by Defence to provide accounting and taxation advice advised ANAO that 'each of the matters raised by the ANAO were clearly addressed in our original advice to the Department of Defence dated 18 February 2003 and we believe our interpretation of these and the independent advice cited in support of these assessments are sound'. Defence responded that it does not agree with the ANAO conclusion that the lease of the buildings should be classified as a finance lease. Detail supporting Defence's position is included at the end of Appendix 1.

Additional accommodation requirements

4.16 Prior to the ADC Weston Creek property being put to the market for sale and long term leaseback, a need for additional accommodation on the site had been identified within Defence. A new permanent Headquarters and Administration building, and an extension to an existing building[38] were proposed to address the increase in student numbers and demand for use of the ADC's facilities since it commenced operations at the Weston Creek site in January 2001.[39] The additional accommodation would also allow more efficient use of the educational facilities on the site. However, prior to marketing the property, the requirement for the additional accommodation, the relative priority for the capital works, and/or the increased lease payments had not been formally approved within Defence.

4.17 Key milestones in the consideration of additional accommodation for the ADC Weston Creek site, and the tender process for the sale and leaseback of the property, are detailed in Figure 4.1. This analysis highlights how the new facilities process and the tender process proceeded simultaneously, with decisions on each process being insufficiently incorporated into the other. The completion of the sale of the property was identified as presenting a risk to

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[38] The extension to the CDSS building was also proposed to enable the ADC to fulfil the mandate given by the Defence Secretary and the Chief of the Defence Force, to further develop international relationships by taking more international students from a wider variety of backgrounds.

[39] Since January 2001, the ADC has expanded to include the Centre for Professional Development, the Centre for Defence Command, Leadership and Management Studies, and to provide support for Reserve training.

achieving the Budget revenue estimate. However, ANAO noted that the monthly reporting on the property prepared for the IDC overseeing the 2002–03 Defence property sales did not refer to the requirement for additional accommodation on the site.

Figure 4.1

Consideration of Additional Accommodation requirements

New Facilities Process	Date	Tender Process
Re-organised ADC commenced operation following refurbishment of Weston Creek site, offering tri-Service officer training.	1 January 2001	
	2001–02 Budget	Sale approved subject to Finance advice on consistency with CPPs.
	2002–03 Budget May 2002	ADC Weston Creek one of 41 Defence properties approved for sale in 2002–03.
Estate Capability Requirement submitted for ADC Weston Creek, specifying need for additional accommodation at the site. ADC requested requirement be included in sale agreement.	September 2002	
Major Facilities Program, listing approved Defence infrastructure projects, excluded ADC Weston Creek as property included in sale program. Requirement to be addressed in lease arrangements.	November 2002	
Cost estimate report by consultant engaged to prepare a development proposal for additional accommodation.	December 2002	
ADC advised agreed option for providing for development on leased site was the inclusion of lease conditions giving Defence development rights.	8 January 2003	
	30 January 2003	Sale and leaseback risk analysis prepared by Sales adviser.
Consultant provided Design Brief for additional accommodation.	February 2003	

New Facilities Process	Date	Tender Processes
	5 March 2003	RFT issued—including draft Crown Lease with increased GFA for site, negotiation clause in RFT for new facilities, and reference to consultant's Design Brief for new facilities available on request.
	11 April 2003	Tender closed.
Defence Infrastructure Sub-Committee agreed to endorse the Corporate Services Infrastructure Requirement for additional accommodation and to progress it as a Private Finance Initiative.	1 May 2003	
	2 May 2003	Exchange of Contract for Sale. Additional facilities not specifically catered for in contract documentation.
Defence sought proposal for continued consultancy services to prepare Strategic Business Case for additional accommodation (proposal accepted 30 May 2003).	9 May 2003	
	13 June 2003	Lease commencement.

Source: ANAO analysis of Defence records

Tender process

4.18 The Head of Infrastructure Division in Defence advised the Commander of the ADC on 1 February 2003 that there was a Government directive to achieve the sale and leaseback in 2002–03 and that the sale and leaseback could be structured to permit the new construction required.

4.19 However, on 24 February 2003, it was agreed within Defence that the sale and leaseback process would proceed with only a negotiation clause in the RFT. Reference to new facilities was confined to the RFT on the basis of advice to Defence from external consultants to the sale and leaseback process.[40] The movement away from inclusion of development rights also appears to have

40 All advisers were engaged after the decision was made to put the property on the market, and on the basis that the sale and leaseback transaction was to be completed prior to 30 June 2003.

resulted from consideration of advice from the sales and legal advisers and discussion at the PCG meeting of 29 January 2003.[41]

4.20 The sales adviser's role was to provide advice, from a commercial perspective, to ensure that the property presented to the market was attractive to potential purchasers. The sales adviser considered that, without certainty of approval for the requirement or for the capital or rental funding, reference to an additional accommodation requirement on the site in the sale and leaseback documentation was likely to introduce risk into the investment decision for the prospective purchaser.

4.21 The position of the sales adviser was that the greater the degree of uncertainty regarding the development, the more conservative the market would be in the assessment of that risk. The sales adviser considered a degree of certainty was required to allow the market to effectively value the asset being offered for sale and leaseback, and that a better sale price would be achieved from the market if the commercial risks associated with future development were removed.

4.22 The legal adviser was engaged to provide assistance in the preparation of all documentation for the sale and leaseback of the property, including the RFT, Contract for Sale and Lease arrangements. The legal adviser was concerned about the enforceability of development rights for the site without greater specification of those rights. The legal adviser considered that providing details about possible future accommodation requirements would increase the risk that tenderers may be misled or confused. The clause included in the RFT was constructed to minimise this risk by disclaiming any warranty or representation by the Commonwealth.

4.23 The RFT was issued with three clauses relating to additional accommodation requirements for the ADC as follows:

- the first clause required tenderers to commit to meet with Defence, at Defence's request, to 'undertake good faith negotiations relating to any proposal for the construction of new buildings or extensions to existing buildings (collectively "New Facilities") upon the Land to satisfy any additional accommodation requirements of Defence';
- the second clause noted that copies of the *Draft Development Option and Base Building Brief* (Draft Brief), relating to the ADC's possible future accommodation requirements, was available to tenderers on request;[42] and

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41 Formal records were not maintained of the Project Control Group (PCG) meetings that occurred after the 14 January 2003 meeting.

42 The RFT noted that the brief would not be relevant to the tender evaluation process.

- the third clause stated that by submitting a tender, each tenderer acknowledged that nothing in the two preceding clauses, the draft brief or any provision in the Crown Lease allowing the construction of any new facilities on the land,[43] would 'create any enforceable rights or obligations between a Tenderer and the Commonwealth other than to meet and negotiate in good faith'.[44]

4.24 The day before the sale was approved, the Defence Infrastructure Sub-Committee (DISC) considered the Corporate Services Infrastructure Requirement for additional accommodation at the ADC Weston Creek and agreed to endorse the proposal seeking approval to provide facilities for a new Headquarters building and extension to an existing building at the site. It was noted that the proposal would be progressed as a Private Finance Initiative (PFI) submission.[45] The Minutes of the DISC meeting noted that the Committee took into account that 'a clause has been added in the sale contract to allow for negotiations to include a new building, built by the new owner to College specifications, on the site'. The DISC noted that additional accommodation will allow the ADC to support additional full fee paying students,[46] and it was estimated that this additional revenue would cover the additional leasing costs of the new building. The DISC agreed that a document, in the form of a PFI submission, would be developed to go to the Minister, Finance and Government.[47]

4.25 No reference to the additional facilities was included in the Contract for Sale or Lease. The legal advice to Defence was that the provisions relating to new facilities, included in the RFT, should not be included in the Contract for Sale or the Sublease as they were essentially unenforceable. The obligation in the RFT to negotiate did not create any meaningful rights for Defence as there was no remedy for non-performance.

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43 Prior to release of the RFT, the Crown Lease was amended to increase the Gross Floor Area (GFA) by 1500 square metres, to accommodate the additional facilities required.

44 The lease noted that the first two clauses did not constitute a warranty or representation that the Commonwealth would have any additional accommodation requirements, nor that approval had been given for the funding of a tenancy for any additional accommodation.

45 The *Commonwealth Policy Principles for the Use of Private Financing*, issued by the Minister for Finance and Administration in June 2002, establishes policy principles and processes for the use of private financing by Commonwealth departments. The document states that 'the term "Private Financing" refers to a form of Government procurement involving the use of private sector capital to wholly or partly fund an asset—that would have otherwise been purchased directly by the Government—which is used to deliver Commonwealth Government outcomes'. The private sector acquires the underlying asset or infrastructure and in return the Commonwealth makes a long term commitment to pay for the resulting outputs.

46 The ADC generates revenue from full fee paying overseas students.

47 On 2 May 2003 the preferred tenderer was approved for the sale and leaseback of the property and the Contract for Sale was exchanged.

Post-sale risk exposure

4.26 Immediately following the sale, Defence sought and accepted a proposal for continued consultancy services from the firm initially engaged to prepare the design brief for the additional facilities for the ADC. Defence advised the firm that it planned to seek approval for additional facilities through a PFI and that it would approach the purchaser with a proposal for the delivery of the agreed scope of works in return for a negotiated increase in annual rent.

4.27 Defence's responsibility in approving the sale and long term leaseback of the property was broader than achieving the highest sale price for the property. As the ADC will have a long term interest in the site, through an initial lease term of 20 years, it was also important for Defence to ensure that the terms and conditions of the sale and leaseback arrangement provided Defence with the flexibility to meet the needs of the ADC over the term of the lease.

4.28 The ANAO found that the interests of the Commonwealth have not been adequately protected in the documents supporting the sale and leaseback of the ADC Weston Creek property, in the event that Defence approves the provision of additional accommodation on the site during the term of the lease. The lease executed with the new owner of the property does not include a specific clause giving the Commonwealth, represented by Defence, any development rights for the site. There is no provision that entitles Defence to make alterations or additions to existing buildings, or to erect new buildings, unless the new owner agrees and the cost of those works are met by Defence.[48]

4.29 It could be difficult for Defence to demonstrate value for money in funding construction on land it does not own, as it would require capital amortisation over a limited lease term rather than over the useful life of any new building(s). If Defence is given approval to construct a new building and/or to extend an existing building, the current lease does not require the owner to provide any consideration at the end of the lease for alterations or additions funded by Defence that improve the capital value of the property at the end of the lease term. Unless otherwise agreed, any improvement to the property will form part of the owner's asset at the end of the lease.

4.30 If the requirement for additional accommodation is approved, and the new owner agrees to fund the construction, there is no provision in the lease for the manner in which additional works, including new buildings, will be carried out, or how the financial arrangements will apply. The current lease

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[48] The costs of the works are required to be met by Defence unless those works relate to a repair obligation on the Lessor under the lease.

does not require the new owner to build to particular technical or financial conditions, or to meet particular quality specifications. Also, the lease does not provide any guidance on the process of negotiating lease terms and conditions for the additional accommodation.

4.31 Estimates within Defence of the leasing costs for the additional accommodation required by the ADC have been based on the net lettable area of the proposed new building and extension, charged at the rate per square metre included in the current lease with the new owner. ANAO considers that, if the owner agrees to construct the new facilities, it is more likely that a commercial rate of return will be imposed to recover the investment over the lease term negotiated for use of those facilities.

4.32 On 11 August 2003 a course of action to progress the project to provide additional facilities at the ADC Weston Creek was approved. The date for completion of the project was revised and estimated for December 2004. The Defence Minute noted that 'the College is unable to continue to meet the demands placed on it by Defence without the provision of additional facilities'.

4.33 On 6 November 2003 the DISC considered a Detailed Business Case for the ADC Weston Creek, to proceed with negotiations with the new owner of the property for the new facilities on the basis of a pre-commitment lease. The DISC did not approve the paper as the Chief Finance Officer had not agreed to a source of funding. It was noted that Ministerial approval was required as the NPV of the proposed lease payments was estimated to exceed $5 million.[49] It was also noted that the expectation that the work would be completed in time for the 2005 student year was optimistic and high risk.

4.34 Defence advised ANAO in April 2004 that:

> A draft Ministerial Submission on the requirement for additional college facilities has been prepared and is being cleared within Defence. If the proposal is approved by the Minister, Defence will engage with the new owner of the ADC regarding the requirement. A final decision on how Defence delivers the requirement will be subject to value for money considerations based on the negotiations with the ADC owner.

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49 In July 2003, costs for the additional facilities required by the ADC Weston Creek were estimated at $5.4 million, including capital costs of $3.9 million and fit-out and carpark costs of $1.5 million.

Recommendation No.5

4.35 ANAO *recommends* that, where a property is to be sold with a long term leaseback arrangement to the Commonwealth, plans for any future accommodation needs on the site over the term of the proposed lease, and the accompanying approval processes, be considered in the timing of the sale process and the terms and conditions of the contract and lease documents.

Defence response

4.36 Agreed.

Canberra ACT
8 July 2004

Oliver Winder
Acting Auditor-General

Appendices

Appendix 1: Lease classification for the ADC Weston Creek property

Australian Accounting Standard 17 'Leases' (AAS 17) requires that a lease must be classified as either an operating lease or a finance lease at the inception of the lease.[50] AAS 17 states that the classification of a lease depends on its economic substance. AAS 17 also provides criteria presented as guidelines to assist in the classification of leases, described in this report as prescriptive tests.

Economic substance

The definition of economic substance provided in AAS 17 is presented in Figure A1.

Figure A1

AAS 17 Definition of economic substance

> **Economic substance**
>
> Where substantially all of the risks and benefits incident to ownership of the leased asset effectively remain with the lessor, the lease is an operating lease. Where substantially all of these risks and benefits effectively pass to the lessee, the lease is a finance lease.
>
> The risks of asset ownership include those associated with unsatisfactory performance, obsolescence, idle capacity, losses in realisable value, uninsured damage and condemnation of the asset; the benefits include those obtainable from the use of the asset and gains in realisable value.

Source: AAS 17 Leases

Figure A2 identifies risks, exposures and benefits under the terms and conditions of the Lease for the ADC Weston Creek property. Under the economic substance criteria, the Commonwealth and the lessor share certain risks and benefits incident to ownership. However, the ANAO considers that the majority of these risks reside with the Commonwealth as lessee, indicating a finance lease. The responsibilities of the Commonwealth under the long term lease, the Defence proposal for additional accommodation on the site during the current lease term, and the restrictions on the use of the land imposed by the Crown Lease contribute to this assessment.

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50 AAS 17 defines a finance lease as 'a lease under which the lessor effectively transfers to the lessee substantially all the risks and benefits incident to ownership of the leased asset and where legal ownership may or may not eventually be transferred'. An operating lease is defined as 'a lease under which the lessor effectively retains substantially all the risks and benefits incident to ownership of the leased asset'.

Figure A2

Attribution of risks under the lease

Commonwealth risks and benefits	Lessor risks and benefits
Responsible for all the Lessor's periodic outgoings. Responsible for all service charges, statutory charges and insurance premiums.	Exposure to costs under the lease are limited to repair and maintenance of the structure, and replacement of obsolete building services plant and equipment and civil works.[1] The AVO assessed the facility to be in an excellent state of repair in its market valuation report, representing equivalent to A grade office type accommodation. Based on the condition of the near new facilities at the commencement of the lease, few structural repairs are likely to be necessary during the term of the lease, and damage from outside forces is likely to be covered by insurance paid for by the Commonwealth.
Responsible for the day to day operation and maintenance of the building services plant and equipment and civil works, including maintenance of the grounds. The Commonwealth is also responsible for repair of civil works.[1] Any upgrades works or alterations and additions, required by the Commonwealth, are to be carried out at its cost.	The risk of obsolescence is small because of the age and condition of the facilities. However, the Lessor is responsible for replacing any part of the building services plant and equipment and civil works that may become obsolete.
The risk of idle capacity lies with the Commonwealth over the term of the lease, as the whole property, including land and buildings, is leased and there is no right for the Commonwealth to sublease.	The risk of losses in realisable value reside with the Lessor. However, during the term of the lease, the rent is likely to be a major factor in determining the realisable value. The Commonwealth, as lessee, has underwritten this rental income stream via the long term lease of 20 years, and with the option to extend for a further 10 years. Gains in realisable value accrue to the Lessor. The capital value of the property has essentially been preserved through the Commonwealth's commitment to the long lease period.

Commonwealth risks and benefits	Lessor risks and benefits
The majority of the risks for condemnation of the asset lie with the Commonwealth as it is responsible for the ongoing maintenance of building services plant and equipment and civil works.	
During the term of the lease the Commonwealth is entitled to uninterrupted possession and enjoyment of the property.	Under the terms of the lease, any gains in realisable value for the property will be realised by the Lessor.

Note: (1) Civil Works is defined in the lease as 'constructed hard standard surfaces, kerbing and guttering of the carparking areas, roads, paths and grounds of the Land and the external lighting and pipes servicing those areas'.

Source: ANAO analysis of executed lease and AVO market valuation.

The risk for uninsured damage lies with both the Lessor and the Commonwealth. While the Lessor must insure the property, those premiums are paid for by the Commonwealth. The Commonwealth is also responsible to make good any damage it causes to the structure or building services plant and equipment, caused by uninsured risk. The Commonwealth is also required to reimburse the Lessor for all excesses and deductibles paid by the Lessor as a consequence of claims for loss or damage it has caused or contributed to.

Other issues that impact on the lease classification are the remote commercial and retail location of the site, and the limited alternate uses for the property as the purpose clause in the Crown Lease does not provide for use as commercial offices. Also, while Defence may be able to seek alternative premises, the facilities on this site were purpose built by Defence for educational purposes. The ADC was recently established at Weston Creek to consolidate certain education and training requirements for the three Services at the one site. Economy and efficiency were factors contributing to the rationalisation of separate Service training establishments and the consolidation decision.

Presumptive tests

While the economic substance of the lease is the overriding consideration in classifying the lease, AAS 17 also provides that a finance lease is normally assumed where certain criteria are satisfied. (See Figure A3)

Figure A3

AAS 17 Presumptive tests

Presumptive tests

AAS17 provides the presumptive tests for classifying leases as finance or operating leases. The standard states that:

> The effective passing of substantially all of the risks and benefit incident to ownership from a lessor to a lessee is normally presumed where <u>both</u> of the following criteria are satisfied:
>
> (a) the lease is a non-cancellable lease
>
> (b) <u>either</u> one or both of the following tests is met:
>
> i. the lease term is for 75 per cent or more of the remaining economic life of the leased asset
>
> ii. the present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90 per cent of the fair value of the leased asset at the inception of the lease.

Source: AAS 17 Leases

The Lease for the ADC Weston Creek property is non-cancellable in that the penalty for cancellation is likely to deter that action. Under the lease terms and conditions, a defaulting party must indemnify the other party for any loss or damage suffered. Therefore the Lease cannot be voluntarily cancelled by the Commonwealth without paying damages to the Lessor. If the property is damaged, destroyed or rendered inaccessible, and the property is not able to be occupied for more than two years, the lease can be terminated.

The ANAO assessed that the current lease term is for less than 75 per cent of the remaining economic life of the leased asset. The AVO assessed the remaining economic life of the property to be 40 years, subject to a refurbishment program in Year 20.[51] However, the ADC has proposed the need for new facilities on the Weston Creek site and Defence has documented that the College is currently unable to meet the demands placed on it without the provision of additional facilities. To economically justify the construction of new facilities on the site, given the terms and conditions of the current lease, ANAO considers it is likely that a longer lease term will be negotiated.

AAS 17 provides guidance on the discount rate to be applied in the calculation of the Present Value (PV) of the lease payments. Where the lessee knows the fair value of the asset at the inception of the lease, in this case the sale price for

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51 AVO Valuation Report of the ADC Weston Creek, prepared for Defence as at 1 January 2003.

the property, and the lessee is able to make a reliable estimate of the residual value of the asset at the end of the lease term, the implicit interest rate can be computed. AAS 17 also provides that, where the lessee cannot reliably estimate the residual value of the asset, the lessee's incremental borrowing rate is used. Given the long term nature of the lease, and the expectation that Defence will require additional accommodation on the site over the term of the initial lease, the ANAO does not consider that a reliable estimate of the residual value of the property can be determined at the inception of the lease. The applicable discount rate for the PV calculation is therefore the Commonwealth Bond Rate at the point of sale.[52]

On this basis, the ANAO assessed that the present value at the beginning of the lease term of the minimum lease payments exceeded 90 per cent of the fair value of the leased asset at the inception of the lease. As the Lease is for the whole of the land and the building, AAS 17 requires that the minimum lease payments be apportioned between the land and the buildings in proportion to their relative fair values at the inception of the lease. Based on the market valuation prior to sale, the portion applied to buildings was 87 per cent. The calculation provided for an annual 3 per cent increase in lease payments over the 20 year term of the lease. The present value figure exceeds 100 per cent of the apportioned sale price.

The ANAO considers that the criteria included in the presumptive tests have been satisfied, allowing a presumption that there has been an effective passing of substantially all of the risks and benefit incident to ownership from the lessor to the lessee. Therefore the lease of buildings for the ADC Weston Creek property is a finance lease.

Defence response

Defence responded that it does not agree with the ANAO conclusion that the lease of the buildings should be classified as a finance lease.

In response to the ANAO position that the limited alternative uses for the property imposed by the Crown Lease, and the remote location of the site, impact upon the lease classification, Defence commented:

> Defence considered that the relevance of these limitations to the accounting classification of the lease are open to question, and were in fact considered and discarded during the Defence evaluation of the lease for the following reason. Due to the length of the lease, the likelihood that the location will remain remote during the lease term is open to question, and in fact development in the vicinity is already proceeding. Continued development in the vicinity will

[52] The 10 year Commonwealth Bond rate for May 2003, published by the Reserve Bank of Australia, was 4.87 per cent.

> undoubtedly generate pressure and an imperative for a change to the purpose clause.

In response to the ANAO position that to economically justify the construction of new facilities on the site, given the terms and conditions of the current lease, it is likely that a longer lease term will be negotiated, Defence responded that:

> although this may be an outcome it would surely depend upon the nature of the new facilities and any changes to the purpose clause which could eventuate.

In response to the ANAO position that a reliable estimate of the residual value of the asset cannot be determined, allowing use of the Commonwealth Bond Rate as the discount rate in calculating the NPV of the minimum lease payments, Defence commented:

> Defence disagrees that a reliable estimate of residual value of the asset at inception of the lease cannot be determined, and therefore argues that the discount rate to be used to determine the NPV of the minimum lease payments should be the internal rate of return from the lease. The use of this discount rate reduces the NPV figure to less than 90 per cent of the sale price.

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