

LEGISLATIVE ASSEMBLY FOR THE AUSTRALIAN CAPITAL TERRITORY

**REPORT ON
THE LEASE/LEASEBACK
OF THE MAGISTRATES COURT AND THE DAME PATTIE
MENZIES BUILDING**

STANDING COMMITTEE ON PUBLIC ACCOUNTS
Report Number 32

December 1997

RESOLUTION OF APPOINTMENT

The Standing Committee on Public Accounts was appointed by the Legislative Assembly on 9 March 1995 with the following terms of reference:

- (a) examine:
 - (i) the accounts of the receipts and expenditure of the Australian Capital Territory;
 - (ii) the financial affairs of authorities of the Australian Capital Territory; and
 - (iii) all reports of the Auditor-General which have been laid before the Assembly;
- (b) report to the Assembly, with such comments as it thinks fit, any items or matters in those accounts, statements and reports, or any circumstances connected with them, to which the Committee is of the opinion that the attention of the Assembly should be directed;
- (c) inquire into any question in connection with the public accounts which is referred to it by the Assembly and to report to the Assembly on that question; and
- (d) inquire into and report on the implementation of the *Public Sector Management Act 1994* with particular reference to:
 - (i) the public interest; and
 - (ii) any other related matter.

MEMBERSHIP OF THE COMMITTEE

Mr Andrew Whitecross MLA (From 18 February 1997. Elected Committee Chair 19 February 1997)

Ms Louise Littlewood MLA (From 18 February 1997. Elected Deputy Committee Chair 19 February 1997)

Ms Lucy Horodny MLA

Mr Bill Wood MLA (From 26 March 1996 to 18 February 1997. Former Committee Chair)

Mr Trevor Kaine MLA (To 18 February 1997. Former Deputy Committee Chair)

Ms Rosemary Follett MLA (To 26 March 1996. Former Committee Chair)

Secretary: Bill Symington

Assistant Secretary: Fiona Clapin

1. INTRODUCTION

Establishment of the inquiry

1.1. On 5 March 1997, on the motion of Ms Horodny, the committee resolved to inquire into and report to the Assembly on the lease/lease back of the Magistrates Court and the Dame Pattie Menzies Building.

What is leaseback?

1.2. Leaseback is where a property is sold or leased to another party and the property is then leased back by the original owner. Effectively, the owner of a building (or other asset) agrees to pay rent for that building and then sells the rental stream to another party for a capital sum.

The Government's budget strategy

1.3. The Government's 1996/7 budget strategy provided for the lease back of the ACTION bus fleet, the Magistrates Court and the Dickson Office Building (subsequently named as the Dame Patti Menzies Building) as the means of funding expenditures in that year. However in early 1997, the Government announced it would not be proceeding with the leaseback of ACTION buses as tax implications were likely to make the transaction uneconomical.

1.4. OFM advised that the lease/leaseback of the Magistrates Court and Dame Pattie Menzies Building is viable because they are new buildings and, under leaseback, the costs of occupancy will be more visible. OFM also advised that the taxation implications which led the decision not to proceed with the sale/leaseback of ACTION buses would not apply in this case.

Estimates Committee 1996/97 consideration of leaseback

1.5. The Select Committee on Estimates 1996/97 inquiry was not satisfied that all issues relating to leaseback had been fully examined and suggested that these arrangements were effectively another form of borrowing by mortgaging assets.¹

1.6. The Estimates committee was advised that the Government expected to raise some \$100m in the 1996/97 financial year from asset management arrangements. During its inquiry, that committee received advice that the sale and leaseback of ACTION buses would allow accrual of taxation benefits to the financier but the

¹ Select Committee on Estimates 1996/97 *Report on the Appropriation Bill 1996/97*, November 1996, pp13-14.

leasing of the Magistrates Court and the Dame Pattie Menzies Building would not result in any taxation benefits to either the government or the lessors.²

1.7. The Estimates committee queried the value of the leaseback arrangements for the new Magistrates Court Building. The committee noted that the fifteen year life of the leaseback arrangement represented a significant expenditure for no additional return, as the capital realised on the arrangement would be paid into Consolidated Revenue. There was a view that the funds could have been better spent providing additional services to the ACT community.³

1.8. The Estimates Committee also considered the benefits of leaseback to be short term and to not address underlying problems with the ACT Budget. The committee was also concerned that the leaseback arrangement for the Magistrates Court Building might impair the appearance of total impartiality which was essential to the ACT's justice system.

1.9. However, the Estimates Committee was unable to examine the leaseback arrangements in any detail as the arrangements had not been finalised. As a result, the committee could only consider "in principle" issues and recommended that the Standing Committee on Public Accounts inquire in more detail once the transactions were finalised.

Inquiry process

1.10. The committee was briefed by the Office of Financial Management (OFM) on the leaseback issue and subsequently took evidence from the agency in a public hearing on Wednesday 30 April.

2. CONSIDERATION OF THE ISSUES

Details of the arrangements

2.1. The lease/leaseback arrangements for the Magistrates Court and the Dame Pattie Menzies Building were subject to a call for expression of interest managed by the Commonwealth Bank on behalf of the OFM. The successful tenderer was Bankers Trust Ltd at a price of \$49.2m. (This compares to the budget estimate of \$43m.) A short list of two parties was selected on 6 December 1996. According to OFM, rankings were based on the cost margin (including underwriting fees) above the 90 day Bank Bill Swap Rate (BBSR). (This is the rate normally used by the Territory for borrowings). One tenderer withdrew prior to final pricing.⁴ As a result only one tenderer submitted a final price.

2.2. Legal documentation was signed on 24 January 1997. Under the lease/leaseback arrangements ownership of the property remains with the Territory. The committee was advised that while this entails all ownership risks, both buildings

² *ibid*

³ *ibid*, pp19-20.

⁴ Letter from NJ Morgan, Office of Financial Management, dated 2 April 1997.

are new and the Territory rather than the potential purchaser will receive any benefits from the investment. OFM also advised that while the cost of funds was 23.5 basis points above the bank bill swap rate, the Territory faced no interest rate risk.⁵

2.3. The committee was advised that the leasing documentation required that both buildings be subject to external insurance and the Government be responsible for paying stamp duty. Also, the Bankers Trust had a right to assign the sub-lease, subject to the Territory's agreement. The committee was advised the Territory is now committed to quarterly lease payments indexed at 3.25% per year, that the base rents were fixed at market levels (reflecting depressed property markets) and that indexation implied modest real growth.

2.4. Under the lease/leaseback arrangement the ACT Government retains full responsibility for all the matters traditionally associated with ownership such as maintenance and insurance of the buildings.

Treatment of Leaseback as borrowings

2.5. The budget papers claimed that leaseback arrangements free up considerable capital, negate the need for any new borrowing in the current budget and allow for debt to be retired.⁶

2.6. The Chief Minister proffered the view that sale (and leaseback) permit a lower level of borrowing which reduces interest costs⁷.

2.7. The committee noted views put forward by Auditor-General's Report No.3 of 1997-1995/96 *Territory Operating Loss* that sale and leaseback or other financing type arrangements to meet the Territory's liabilities as they emerge are similar in financial terms to borrowings. The Auditor-General observed that substantial increases in these types of arrangements would be contrary to a low debt policy.⁸

2.8. A similar conclusion was drawn in Auditor-General's Report No.9 of 1997 - *Fleet Leasing Arrangements*.

2.9. In advice to the committee in relation to its August 1997 report no 28 on the 1995-96 Territory Operating Loss, the Chief Minister acknowledged that leaseback commits the Territory to future rental payments or paying rental for accommodation and other services as the services are received by the Territory⁹.

2.10. The committee considers that evaluation of the current arrangements has been hampered by a lack of clarity over the real goals of the transaction with too much emphasis being given by the Government in seeking to draw a distinction between the arrangements and borrowings.

⁵ Letter from Chief Minister to Chair of Standing Committee on Public Accounts, dated 19 February.

⁶ *Budget Paper No. 1, 1996/97*, p20.

⁷ Letter from Chief Minister, op cit

⁸ Auditor-General, *1995/96 Territory Operating Loss Report No.3, 1997*, p21.

⁹ Chief Minister. Letter to the committee dated 17 June 1997

2.11. The lease/leaseback arrangements are in all respects equivalent to borrowings; having the same annuity structure in which a capital sum is exchanged for a series of payments.

2.12. The committee concludes that the lease/leaseback arrangements are effectively another form of borrowing and that evaluation of the appropriateness of these arrangements should focus on the relative costs and benefits of lease/leaseback compared with normal borrowing.

Management of interest rate risk

2.13. One benefit proposed by OFM for the lease/leaseback approach was the management of interest rate risk.

2.14. Up until these transactions, ACT Government borrowings were linked to the 90 day BBSR which OFM advised involved smaller interest costs but which would involve a much higher interest rate risk over the term of the transaction.¹⁰ By contrast, the lease/leaseback arrangement involved the use of long-term interest rates equivalent to the 15 year BBSR.

2.15. OFM argued that the traditional reliance on 90 day borrowings was never part of a planned approach and the lease/leaseback strategy would have long-term benefits.¹¹

2.16. The first of these benefits was reducing volatility associated with short-term interest rates. In this regard, OFM advised that:

the most important contributor to lowering debt costs over time is managing interest rate risk. This is more important than changing the underlying debt (substituting high cost debts with low cost debts of the same maturity) without changing exposure to interest rates. The lease/leaseback model is a form of financing that does not involve interest rate risk.¹²

2.17. The committee was advised that in considering the lease/leaseback option the Government was aware of market conditions both for property in the ACT and for interest rates at a national level. OFM put the view that the trend to an increase in the basis points for swap rates confirmed the judgement that there was potentially substantial gain to the Territory by capitalising on the interest rate market conditions in the second half of 1996 and early 1997.¹³

¹⁰ Trans p8

¹¹ *ibid*

¹² Letter from NJMorgan, *op cit*

¹³ Letter from NJ Morgan, Office of Financial Management, dated 2 April 1997.

2.18. It was also claimed that the changes in long term rates that have occurred since the transaction was completed would mean the Government had already achieved substantial benefit from the transaction.¹⁴

2.19. The committee is reluctant to accept long-term benefits from these transactions based on month by month movements in long-term interest rates. The long-term benefits will not be measurable until the end of the lease/leaseback period.

2.20. However, the committee found that the effective interest rate implicit in the lease/leaseback arrangements is 23.5 basis points higher than the 90 day BBSR which the Territory has traditionally borrowed on, which means that in the short term the Territory's costs are actually higher for 1996-97 and 1997-98 than they would have been had the Territory borrowed the amount realised from the lease/leaseback arrangement.

2.21. It was further argued that a long-term benefit of lease/leaseback was matching liabilities to assets. In this regard OFM argued that effective management required matching short term liabilities with short term assets and matching long term liabilities with long term assets and that the lease/leaseback model met this criteria.¹⁵

2.22. Although OFM argued that the lease/leaseback arrangement was part of a planned approach, the committee was not presented with any evidence of a wider plan in regard to borrowings other than the lease/leaseback arrangements under examination.

External insurance

2.23. One requirement imposed by Bankers Trust for the lease/leaseback was that the Territory take out insurance over the buildings concerned. The committee understands that public and industrial risk liability insurance on the Magistrates Court and the Dame Patti Menzies buildings and their contents was subsequently taken out at a cost of some \$30,000 for the first year (and presumably will be renewable at around the same figure in subsequent years).

2.24. In the past the Territory has self insured its property; that is, it has accepted the insurance risks associated with its buildings.

2.25. The use of external insurance of both buildings was an obligation entered into by the Territory under the lease agreement. The provision was described by the Chief Minister as a prudential measure for major property assets that needed to be addressed irrespective of (the lease) transaction as it provides added security to the Territory.¹⁶

¹⁴ Transcript,p9

¹⁵ Letter from NJMorgan, op cit

¹⁶ Chief Minister letter to committee, op cit

2.26. Although the argument was put that the use of external insurance was justified by wider policy considerations, the committee was not presented with any evidence of a wider plan in regard to external insurance other than the arrangements under examination.

2.27. Auditor-General's report No 9, 1997 referred to the realisation arrived at late in the negotiations for the sale and lease of ACT Fleet vehicles that the Government's self insurance arrangements would not apply to the leased vehicles because of the taxation implications for the lessor.¹⁷ In this case the cost of external insurance was seen by the Auditor-General as a significant factor in terms of the viability of the leasing arrangement, and a similar conclusion could be drawn in relation to insurance for the lease/leaseback arrangements.

2.28. The committee considers that the decision to use external insurance had more to do with the requirement of Bankers Trust than any wider policy considerations and should be regarded as a cost of the transaction.

3. CONCLUSIONS

3.1. The committee considers that the evaluation of the lease/leaseback arrangements in the budget papers and the views of the Chief Minister (paragraphs 2.5 and 2.6 above) give an incorrect assessment of the real situation.

3.2. Lease/leaseback increases the Territory's liabilities in the same way as debt.

3.3. Assertions that capital is freed up and that lease/leaseback arrangements permit a lower level of borrowing and interest costs ignore the fact that the arrangements involve leaseback payments which are linked to interest rates.

3.4. The effective interest rate implicit in the lease/leaseback arrangements is 23.5 basis points higher than the 90 day BBSR, without factoring in the cost of external insurance, and there must be some doubt as to the benefits of the arrangement over the long-term.

3.5. No evidence was provided to the committee of a wider plan in regard to borrowings other than the lease/leaseback arrangements reviewed in this inquiry

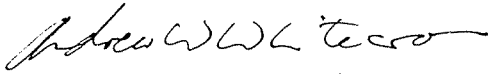
3.6. Further, no evidence was provided of wider policy considerations in relation to external insurance, the decision to insure externally in this case being more a requirement of Bankers Trust than anything else.

4. RECOMMENDATIONS

4.1. **The committee recommends that the Government not enter into any further sale/leaseback or lease/leaseback arrangements until it:**

¹⁷ Auditor-General's report, op cit, p47 et seq

- (i) reports to the Assembly on a comprehensive policy for management of interest and insurance risks; and
- (ii) the Standing Committee on Public Accounts in the next Assembly reviews this policy with a view to establishing its costs and benefits.



Andrew Whitecross MLA
Chair

DISSENTING REPORT
by
LOUISE LITTLEWOOD MLA

I do not agree with the findings or recommendations of this report.

The report is flawed because a majority of members failed to understand the key issues and, in any case, were intent on using the committee process more to pursue a political agenda than to analyse the costs and benefits of the financing arrangements for these assets.

For example, effective management of interest rate risk was a central issue in the lease/leaseback financing arrangement. However, the alternative favoured by the majority of the committee – reliance on short term finance and variable interest rates, which was the practice of the previous government – shows no awareness of interest rate risk management. Although the benefits of the Government's approach were explained to the committee, such information seemed not to suit the purposes of the majority of members.

Similarly, the majority failed to understand and acknowledge the reasons for the major reforms in relation to insurance risk which this Government has initiated. These reforms were introduced in the 1997-98 budget, and insurance for the two buildings considered in this report is consistent with that policy framework. The Government's commercially sound policy on managing insurance risk contrasts with the neglect of this issue by the previous government, but the majority of the committee did not want see that. Hence the issues are not properly addressed in the report.

Turning to the one recommendation, the Public Accounts Committee has had several months to study the costs and benefits of the lease/leaseback arrangements for the Magistrates Court and the Dame Pattie Menzies Building and has not refuted the evidence provided. The recommendation by the majority on the committee to undertake a further reference is unnecessary and unjustified, especially as material provided to the current reference has identified the clear benefits of the financing arrangements entered into for the two buildings. Moreover, the majority appears to agree with, but not acknowledge, the Government's wish to retain ownership and control of these assets.

I therefore cannot support the recommendation and dissent from it.

Louise Littlewood MLA

A handwritten signature in black ink, appearing to read 'Louise Littlewood', written in a cursive style.