

Corporate Property Strategies in the Federal Public Sector

Clive M J Warren

Faculty of the Built Environment

University of New South Wales

Sydney NSW 2052 Australia.

clive.warren@unsw.edu.au

Abstract

The procurement of corporate property has undergone significant change as a result of economic reform at the end of the 1990's. The changing economic climate led business and governments to focus on their property assets. Many governments globally adopted a market driven approach, subjecting non-core service delivery to competitive tendering and contracting with many services outsourced to the private sector. Australia readily adopted the new market approach. The Federal Government undertook a major property strategy review implementing a user pays market system followed by a comprehensive outsourcing of office property. This paper examines the property evaluation process and critically reviews the disposal processes adopted. It illustrates where lack of forward strategic planning led to a significant loss of value to the public purse. The paper concludes with the recommendation that the public sector should establish a clear long term strategic approach.

Key Words:

Facilities Procurement, Federal Government, Property

Introduction

The management of corporate real estate by both the public and private sectors has seen rapid changes in recent times. Changing economic forces have resulted in business becoming more aware of their real property assets and how they contribute to the overall health of the organisation. This financially driven spotlight on operational property assets has seen a dramatic shift in the way that these assets are owned and operated. The private sector is not alone in recognising the value and importance of its asset base. Indeed, in many instances, the public sector has led the way in innovative resourcing strategies and adopting new ways of delivering the work environment.

This paper seeks to identify the trends in real property resourcing within the public sector and illustrates these with examples from the Australian Federal Government which has significantly altered the way that property services are procured and in so doing faced considerable public criticism. The Australian Federal Government has, over the past couple of decades, adopted a number of property strategies which have resulted in critical review by the audit commission and in reported financial losses. The critical review of these procurement processes will illustrate where improvements can be made in the development of future property strategies within both the public and private sectors.

The provision of corporate and facilities management solutions for any organisation must be cost efficient and effective in supporting the delivery of the business objective. In the public sector context, real estate provision must use public funds in the most appropriate manner in order to support the delivery to the community of Government services. The development by the public sector of a long term strategic facilities plan linked to the overall direction of government, in place of an ad hoc series of reactive investment and divestment decisions, is essential in maintaining public expenditure at optimum levels for efficient service administration.

Background

The role of government significantly changed in the last quarter of the twentieth century. The global recession at the end of the 1970s is largely seen as the catalyst for the significant structural changes which occurred throughout the eighties and nineties. The new era of government was one of enabling the delivery of services rather than direct delivery and administration. The philosophy changed from one of the government control through a centralised hierarchy to one of “government by the market”. The “first objective of this new ideology has been to slim the state and liberate market forces in a variety of ways, such as deregulation and through monetary and fiscal policy” P Self (1993 pp59) The market ideology or ‘New Public Management Framework’ as described in Aulich et al (2001,11-19) was adopted across much of the developed world and led to the widespread privatisation of industries no longer seen as core to the delivery of good government.

In Australia, the level of government privatisation was one of the largest among OECD countries with Australia second only to the UK in value terms and second to New Zealand as a percentage of GDP. Reserve Bank of Australia (1997) In 1989 the Hawke government announced ‘The Machinery of Government Reform’ Directions in Government (1993:3). The intention of the new agenda was to reform those sections of government with commercial potential in order to position them for privatisation. This led to a number of significant initiatives which have bearing on the delivery of corporate property strategies for public service accommodation. The ‘Hilmer Report’ on National Competition Policy. Hilmer F et al (1993) and the Industry Commission report ‘Competitive Tendering and Contracting (CTC) by Public Sector Agencies’ Industry Commission (1996), were milestones in the change process and had significant effect on the size of government and property agenda moving forward. Warren, C. (2002)

In a property context the procurement process spans from in-house provision to outsourced management, outsourced ownership or even outsourced service delivery or non-property solutions. Assuming that a service delivery need is identified it is then, from a corporate real estate perspective, necessary to identify a property solution that accommodates the workplace requirements of the public servants charged with service delivery. Thus this raises the usual facilities management dilemma to lease or buy. Research in this wider context has shown that the decision is more dependent on the organisations ability to successfully manage the operational costs of the asset than a financial one in which there is equivalence between leasing and borrowing to acquire the freehold interest. Roland,P. (2001)

Public Sector Real Property Procurement

The extent to which the public sector has embraced the new model of government is particularly relevant to the provision of working environments in which to deliver services to the community. The reform have led to a significant downward trend in the size of government, a drop of 67,000 public servants or 37% between 1986 and 1999, leaves asset managers with a sizable reduction in space provision to address. Aulich et al (2001.9)

The adoption of new management practices has been widely adopted by government in Australia which the Federal Government having perhaps, taken the process further than most States and local government authorities. The Federal Government thus provides an interesting case study of how changes in management philosophy affect the bottom line of service delivery. The Commonwealth or Federal Government had a property holding which, while centred in Canberra, also comprised a great many properties in each of the States and Territories. This estate had been changing in nature over the past few decades as attitudes to property ownership shifted. In 1976 the government directly owned and managed 51% of the office space it occupied, by 1996 this had fallen to 34%. The most dramatic change occurred, however, post 1996 when the level of owner occupied office space fell to almost zero.

Prior to the implementation of the new change agenda at the end of the 1980's office accommodation was managed by the Australian Property Group (APG) which provided a centralised property provision allocated on strict guidelines of space per grade of employee. This system provided little incentive for departments to manage their space requirements. The management of the office estate since the late eighties provides a case study in the rapid change in attitude to property holdings while, at the same time, presenting some considerable areas of concern in the manner in which such objectives are achieved.

The recognition globally that property should no longer be considered a free good led the government to fundamentally alter the methods used to manage its estate. In 1990 Australian Property Group, embarked on a system of internal rental charges to occupier departments based on an internal lease type document or MOU. This public sector commercialisation was defined by the Australian National Audit Office. ANAO, (1992) as:

'The adoption of various business practices akin to those of the private sector. Commercialisation involves a switch in reliance by a department of state on directly provided appropriation based funds, in favour of funds received from clients in payment for products and services.'

This was a fundamental change in APG's role from one of regulator of space use to one of customer service as landlord and developer. Departments which were efficient in their use of office accommodation were able to reduce occupancy costs and reapply surplus budget funds to other elements of service provision. A classic use of internal charging regimes to effect change and to hand the responsibility of costs incurred to the users, results in encouraging savings to the benefit of both parties. This system saw a marked improvement in the performance of the estate with a much higher level of tenant awareness as to the costs of accommodation provision. The recognition of property as a valuable asset was to a large extent responsible for the significant reduction in the size of the owner estate by 1996. An audit of the management practices in 1996 revealed that return from the portfolio was close to that of the broader market and significantly better in some areas. ANAO 29,1996

The most significant change in procurement strategy followed the change of government resulting from the 1996 election. The new government picked up the pace of change appointing a joint public / private sector task force to report on the efficient delivery of office accommodation across the owned and leased portfolio. The private sector advisory committee, the Commonwealth Property Committee (CPC) oversaw the division of the office estate into three regions and the sale of the management of those properties to the private sector as a first step toward outsourcing of property services.

The privatisation of property management was shortly followed by the CPC's establishment of the Commonwealth Property Principles in July 1996. These principles were developed by the CPC in conjunction with the Department of Finance, and state that:

'The Commonwealth should own property where the long-term yield rate exceeds the social opportunity cost of capital or where it is otherwise in the public interest to do so'
ANAO (2001)

The hurdle rate applied to test the ownership criteria was set at 15% and, as a consequence, a rolling programme of asset disposals commenced. The use of a social opportunity cost of capital and the adoption of the 15% hurdle received much criticism at the time that it was launched and subsequently in a National Audit Office review of the process. The basis upon which the hurdle rate was fixed is an interesting lesson in property financing. The Department of Finance (DOF) in 1998 explained the process to the Senate as follows:

'Given that the cost of capital to the Commonwealth is around 12–14 per cent the hurdle rate of 15 per cent used in the financial analysis of the Government's domestic property holdings was arguably too low. The evidence suggests that hurdle rates in the private sector are commonly 15 per cent after tax and that some companies involved in property development use hurdle rates in excess of 25 per cent. At the time the decisions were taken on domestic property, the hurdle rate adopted by Commonwealth GBEs began at around 15–20 per cent. The Commonwealth Property Committee therefore erred on the side of caution using a hurdle rate of 15 per cent. The consequences of this decision would therefore have been that properties that would not meet a higher hurdle rate would have been retained. The Government would, however, be able to dispose of such properties at a later date.' DOF Submission to Senate Finance and Public Administration References Committee February 1998

As criticism of the choice of hurdle rate increased, DOF employed consultants on three separate occasions to advise them of an appropriate measure to apply to the own/sell decision. The first two consultants adopted similar rationales to arrive at a hurdle rate. They utilised the Capital Asset Pricing Model (CAPM) to estimate the expected return from real property in Commonwealth occupation. The first used a risk free rate of 6% and a beta for property estimated as between 0.4 and 0.6, where a most likely estimate of return is 10%. The second consultant, reporting in 1999, was a little more conservative with an expected return between 9 and 11%, recommending the adoption of the higher rate as a maximum. The third consulting firm, hired in December 2000, adopted a slightly different approach by applying the total market risk beta of 1 to the risk free rate and then adding a further 2-3% allowance to reflect the risk associated with property, thus arriving at a figure of 15%. That is the first two consultants adopted similar approaches to determine the appropriate hurdle rate, while the third consultant used a global market risk and added an additional margin to

reflect property risk. This latter approach uses unconventional methodology but was adopted by the Department of Finance and supports the CPP hurdle rate figure of 15% used in the earlier property disposals. ANAO (2001)

The rate adopted and defence thereof is somewhat academic as prior to the appointment of the above consultants in 2000 the majority of properties evaluated against the property principles were earmarked for disposal. A handful were retained and of these only one property was retained on public interest grounds due to the sensitivity of its location within Canberra. The effect of applying the CPP was the identification of 59 major properties for disposal with a market value of AU\$1.05b. This major proportion of the commercial estate was packaged to achieve optimum income and disposed of over a period of three years, between late 1996 and 2000. It was the largest property disposal program undertaken within Australia and accounted for a significant proportion of the total market sales during the period. What is perhaps more significant is that the disposal program accounted for a 20% or \$140 million write down in values. Warren, C (2002) This loss of value has been attributed to a number of factors at the time of disposal. These include:

- A depressed market with high vacancy rates in most major centres
- Static or falling rentals with lease incentives reaching there peak
- Significant vacancies within properties offered for sale as departments had been previously been allowed to negotiate there own requirements in the open market
- The earlier leaseback arrangement for tenants resulted in many departments vacating some or all of their accommodation prior to sale, thus reducing the rental stream
- A resistance to fill vacant space with private sector tenants to increase cash flow
- A large portfolio offered in a relatively short period when the ratio of institutional investment in property was generally being reduced

All of these factors had a part to play in significantly reducing the sale proceeds from the disposal of the public interest in the Commonwealth estate. A few case study examples serves to illustrate the point. The case studies are of the more significant buildings in three State capitals and comprised the three most valuable assets outside of Canberra.

Case One – Sydney Central

Land Acquired 1975

Built 1992 at a cost of \$164m or \$4,300/m²

Valued at \$122.5m in 1994 or \$2,502/m²

Sold 1998 for \$137,550,000 or \$2,809/m²

Current Value; ISPT II trust book value \$ 168.1m or \$3434/m²

Thus this property sold at a significant discount to its construction and replacement cost yet, since the sale, has shown an annualised return of 6%. The super fund that now owns this property however, reported an 11% return from these property assets for the year to June 2002.

Case Two – Casseldon Place Melbourne

Built 1992 at a cost of \$194m or \$2,970/m² excluding fitout
Valued at \$123.75m in 1994 or \$1,895/m²
Sold 1998 for \$142.1m or \$2,176/m²
Current Value; ISPT I trust book value \$207.4m or \$3176/m²

This property has returned the institutional investor over 11.5% per annum since purchase within a portfolio which provided an 11.3% return in the year to June 2002. The sale of this property exceeded the 1994 valuation but is significantly less than the cost of development in 1992.

Case Three – Australian Government Centre Brisbane

Land Acquired 1934 comprising three buildings
Built, Tericca Place 1992 at a cost of \$72m or \$2,549/m²
Valued at \$110m in 1994 or \$2,052/m²
Sold 1998 for \$96,000,000 or \$1,790/m²
Current Value; ING Office Fund book value \$ 137m or \$2,555/m²

This property has provided a return of 10.6% annual growth in the capital value of the asset.

As shown these three 'A' Grade property investments have provided considerable growth in the asset value over the three and a half years since the sale by the federal government of between 6% and 11.5% per annum

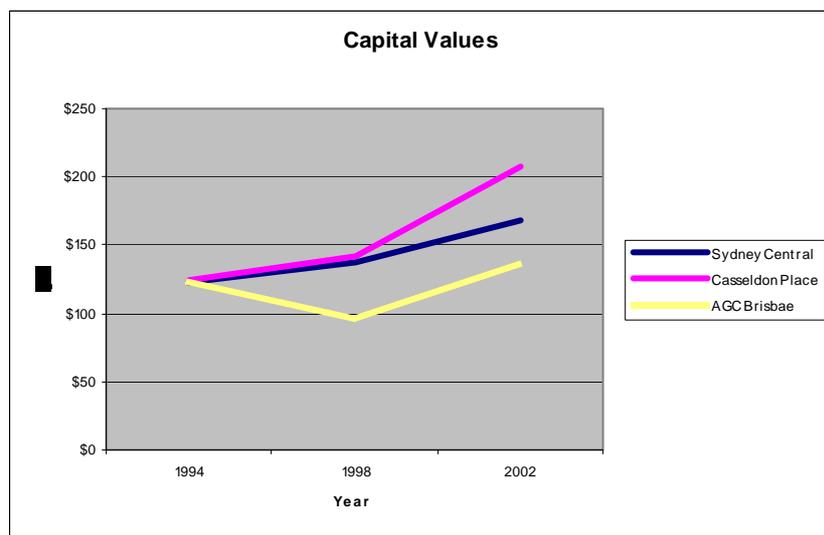


Figure One - Case Study Capital Value 1994 -2002

There are a number of lessons that can be learnt from the Commonwealth Government experience and the methodologies employed in identifying an appropriate and efficient provision of real property solutions for the delivery of organisational goals. The Commonwealth Government had one of the largest property portfolios in Australia and, until the late 1980's, had managed the estate by providing a mix of direct ownership and leasehold properties within detailed regulatory accommodation

standards. The economic reforms of the last part of the twentieth century have caused government to rethink its property procurement strategy and to develop a number of approaches to property service delivery. Some of the early initiatives of enabling departments to make their own property choices within a user pays framework showed promise of reducing costs and increasing efficiency, albeit at a modest rate of change.

The second phase of the reform process, which effectively resulted in a move out of direct ownership of real property, served a number of objectives associated with the process of outsourcing, namely a reduction in cost of service provision, a release of capital tied up in the provision of property and the removal of an administrative burden in the form of a large bureaucracy of public servants managing the property process.

There is little doubt that the process adopted by the Commonwealth relieved government of the burden of property development and the provision of commercial property management services, relying instead on the market to provide these services at a competitive rate. The question that this approach does not answer, and is only partially addressed in the national audit office report of the disposal process, is does this give the occupier departments and ultimately the tax payer the best outcome both financially and in operational efficiency terms?

Conclusion

The conclusions that can be drawn from the Federal Government's disposal process is that corporate property is a long term proposition and that rapid policy change, if not integrated into a whole of life asset plan cognisant of market conditions, can have a marked affect on the value of assets. The government's new procurement strategies reliant on market forces to provide value for money and a preference for short horizon reductions in transaction costs against a consideration of medium term broader issues, does not produce the best outcome for society. Steane and Walker (2000)

The lack of a coordinated Corporate Real Estate Plan which integrates the long term service and policy agenda with the property resources under management and the wider market within which they operate will not provide optimum efficiency. The Federal government's frequently changing procurement policy led to instability in the returns from the properties and a consequential increase in the apparent risk to private sector investors. The government's initial strategy of competitive market equivalent provision of commercial office accommodation would have led, over time, to an equilibrium of owned to leased facilities which were market competitive and aligned with long-term service objectives, thus reducing risk and increasing flexibility.

The decision to change to a wholly outsourced provision of property services could have provided a long term strategic position freeing up capital. However, the implementation of both strategies over a relatively short period of time served to reduce the overall effectiveness of the outcome. The loss of value to the government of some 20% of what might have been achieved from a more appropriate implementation of either scheme independently demonstrates the lack of a high level strategic facilities plan and a less than optimum outcome for the tax payer. The public sector should not be afraid to use its market power in either owner-occupier or leasehold property procurements, but should use its position to add value to the overall service delivery objective via a business integrated strategic facilities plan. Government and similarly private sector organisations should adopt a clear long-term

corporate property facilities resource plan which benefits the public or shareholders by adding value to the organisations core objective.

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