



AUDITOR-GENERAL  
AUSTRALIAN CAPITAL TERRITORY



PA 01/18

16 June 2003

The Speaker  
ACT Legislative Assembly  
South Building  
London Circuit  
CANBERRA ACT 2601

Dear Mr Speaker

In accordance with the Authority contained in the *Auditor-General Act 1996*, I transmit to the Legislative Assembly my Report titled "*Lease of FAI House*".

Yours sincerely

John A Parkinson

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# **1. LEASE OF THE FAI HOUSE**

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## **INTRODUCTION**

1.1 Assertions have been made to the Audit Office that the lease rental rates being paid for occupancy by Territory agencies in a Canberra City building are significantly above the market rate for similar premises. The building is Eclipse House which was formerly known as FAI House. As the assertions came from more than one source it was decided that an audit would be conducted to ascertain whether the assertions were correct.

1.2 There have also been allegations that there could be a connection between the higher rental rates agreed to be paid for the FAI House and the agreement by FAI to be the naming rights sponsor of the 'Rally of Canberra' for four years commencing in 1996. It was decided that procedures would be undertaken to identify whether there was documentation available to support these assertions.

## **AUDIT APPROACH**

1.3 An initial step in the Audit was to engage a suitably qualified valuer to estimate what the market rental rates would have been for Eclipse House on the basis that arms length negotiations between willing and knowledgeable lessors and lessees were carried out at the date of commencement of the lease (1 December 1996) and at 1 January 2003. The Audit then compared the valuer's estimates with the actual rental rates at the commencement of the lease and at the beginning of 2003.

1.4 In addition available documentation was examined to evaluate whether, from the Territory's perspective, adequate processes were used during the negotiations on the lease rate with FAI.

1.5 In relation to the allegations that there was a connection between FAI's naming rights sponsorship of the Rally of Canberra and the rental charges the Audit examined available documentation to identify whether the documentation contained evidence as to whether or not a connection existed.

## **AUDIT OPINIONS**

1.6 The independent audit opinions drawn from this Audit are:

- the rental lease rates being paid by the Territory for occupying the former FAI House were above market when the lease was entered into and continue to be above market; and
- from the Territory's perspective the negotiation process for the rental lease rate for FAI House was inadequate.

1.7 The Audit was unable to form an opinion on whether or not there was any connection between the higher rental rates agreed to be paid for FAI House and the agreement for FAI to be the naming rights sponsor of the Rally of Canberra.

## **PREMISES INVOLVED AND LEASE DETAILS**

1.8 The relevant building is Eclipse House which is located on the Corner of London Circuit and Akuna Street, Canberra City. Eclipse House was formerly known as FAI House.

1.9 Eclipse House is a 10 storey office building over a basement level with the basement level providing storage and rear access for loading. The upper floor levels have good views to the south east and south west. There is no on site parking although there is very limited restricted street parking to the rear of the building and several large public pay car parks in close vicinity on London Circuit. The premises were constructed in 1967 and refurbished and upgraded in mid 1999.

1.10 It is understood that the overall development of Eclipse House contains a net lettable office area of approximately 6,000 square metres.

## **ACT Agencies Located in Eclipse House**

1.11 The following ACT agencies are located in Eclipse House.

- ACT Government Shopfront (Canberra Connect)
- ACT Corrective Services
- ACT Workcover
- ACT Gambling and Racing Commission
- Women's Information Referral Centre
- Health Professions Registration Board

- Department of Justice and Community Safety – Essential Services
- Chief Minister’s Department – Record Services
- Independent Competition and Regulatory Commission
- Family Services
- Insurance Authority
- Canberra Connect
- Bushfire Taskforce and Bushfire Enquiry

**Lease Details**

1.12 The lease entered into in 1996 between the Territory and FAI Properties Pty Ltd (the then owners of the building) provides for:

Lease Term	10 Years
Commencement Date	1 December 1996
Area of the Leased Premises	5138.9m <sup>2</sup> of office space 249.4m <sup>2</sup> of storage space 5914.6m <sup>2</sup> total space
Rental	\$340m <sup>2</sup> per annum for office space \$100m <sup>2</sup> per annum for storage space
Rent Review Dates	1 December 1998, 1 December 2000, 1 December 2002 and 1 December 2004

1.13 The lease also contains a ratchet clause which prevents the annual rental charge for the office space in the building ever being reduced to below \$340m<sup>2</sup>.

1.14 The lease includes a clause providing for a rent reduction for the first two years of the lease. The clause states ‘notwithstanding anything else contained in this lease, if the lessor pays instalments of rent by due dates for payment the lessor will accept during the first two years of the term an amount of \$110760 per month’. The two years were the years ending 30 November 1997 and 30 November 1998. The rent of \$110,760 per month paid for the first two years of the lease reduced the actual rental rate to \$254m<sup>2</sup>.

1.15 The building was acquired by Eclipse Enterprises (NSW) Pty Ltd in 2002. The lease was transferred with no changes from FAI Properties Pty Ltd, to the new owner.

**ABSENCE OF BIENNIAL RENTAL REVIEWS**

1.16 The lease agreement provides for biennial rental reviews which can be initiated either by the lessee (i.e. the Territory) or by the owner. No reviews, however, have occurred. The reviews have not been initiated by the Territory because the ratchet clause (see paragraph 1.11) in the lease ensures the rental can only go up. The owner has not initiated a review because the owner cannot obtain a rent increase through a review to market as the rent is already above market.

*Audit Comments*

1.17 The fact that no rental reviews have been instigated by either the Territory or the owner of the building is strong evidence that the rental rate has been continuously above market rates since the commencement of the lease and this has been known by the Territory and the owner.

**VALUER’S ESTIMATES OF MARKET RENTAL RATES**

**Market Rental Rate at Commencement of Lease**

1.18 The valuer calculated the gross effective annual rental rate being charged in accordance with the lease (i.e. taking to account the rent reduction in the first two years – see reference to rent reductions at paragraph 1.8) as \$323m<sup>2</sup> per annum. The gross effective annual rental rate was calculated by the valuer as follows:

- Rent Reduction  
(First 2 years @ \$110,760 per month) \$2,658,240
- LESS: Storage  
(249.40m<sup>2</sup> x \$100/m<sup>2</sup> x 2 years) \$49,880
- Net Rent after deducting storage (First 2 years) \$2,608,360 (A)
- Gross Face Rental payable for balance of term  
(Years 3-10 inclusive payable @ \$340/m<sup>2</sup>  
for 5,138.90m<sup>2</sup> and assuming no rental growth) \$13,977,808 (B)
- Total Gross Effective Rental payable over whole  
of lease term: (A) + (B) \$15,586,168 (C)
- Gross Effective Rental payable per annum: (C)/10 \$1,658,617 (D)
- Gross Effective Rental payable per square metre:  
(D)/5,138.90m<sup>2</sup> \$322.76m<sup>2</sup>

1.19 The valuers report concludes that the gross effective annual rental rate [\$323m<sup>2</sup>] is considered to have been a premium rate in the market place in late 1996. The valuer's report states:

'Relying on the rental evidence provided we consider the effective rental appropriate at the effective date to be in the vicinity of \$260-\$280/m<sup>2</sup> depending upon the scope of refurbishment undertaken/to be undertaken as part of entering into the new lease commitment. Based on a mid-point rental of \$270m<sup>2</sup> we consider the rental premium payable until the first review date (commencement of Year 3) to be in the order of \$50/m<sup>2</sup> and representing approximately \$257,000 per annum.'

### **Current Rental Rate**

1.20 In relation to the current situation the valuer concluded:

'Referring to the current market rentals section of this report the most comparable rentals applicable to Eclipse House would be 4 Mort Street and the Drakeford Building at \$270 and \$290/m<sup>2</sup> respectively. However the views in Eclipse House are superior although the rental negotiated for The Drakeford Building involved a use of an existing fit out. Taking these factors into consideration and in the context of recent market rental in the Canberra CBD we would expect a market rental for the premises known as Eclipse House to be \$280/m<sup>2</sup> gross effective as at 1 January 2003.'

1.21 Based on the valuers estimates the Territory is currently paying excessive rental of around \$216,000 annually.

### ***Audit Comment***

1.22 Based on the information provided by a well qualified valuer the Audit's conclusion is that the assertions are correct that rental charges being paid by the Territory for occupying the former FAI House are above market rates. As the Audit formed this conclusion it decided to extend the audit to reviewing available documentation to evaluate from the Territory's perspective whether adequate processes were used during negotiations of the lease rate with FAI.

## EVALUATION OF NEGOTIATING PROCESSES

### Absence of Documentation of Negotiations

1.23 The Audit sought any documentation that may have been held in ACT agencies evidencing how the rental rate for FAI House was negotiated. No documentation was forthcoming other than a copy of a facsimile dated 15 August 1996 from an official of the FAI Insurance Group to the then ACT Under Treasurer<sup>1</sup>. The relevant wording of the facsimile was:

It is agreed that FAI will enter into a ten (10) year lease for the current space occupied at the FAI Building, London Circuit, for an agreed rate commencing at \$340 per square metre. These areas are presently a major lease of about 4,450 square metres plus two additional areas recently taken up by the ACT Government equating to approximately 436 square metres. This rate will be reviewed to the market rate every two (2) years with a ratchet clause to the effect that the rate can never fall below \$340 per square metre.

In consideration for entering the lease, FAI will provide a six month rent free incentive of \$756,840. At your convenience I would appreciate it if our Property Manager could contact your Property Manager to arrange the lease to reflect the above details.'

### Territory Property Manager's Advice

1.24 Totalcare Property Management<sup>2</sup> recently advised the Audit that their understanding of the FAI House negotiation process was that while there was an offer from the agent and analysis was prepared by the Department of Urban Services' Accommodation Services Group the final lease negotiations were undertaken by the then Office of Financial Management (OFM) and it was at that stage the rental ratchet clause was agreed. Totalcare are not aware of any formal market testing for comparison or any valuation advice being obtained. Subsequent to the lease negotiations by OFM the lessor did agree and implement significant upgrading of lifts and building services.

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<sup>1</sup> Mr Mick Lilley

<sup>2</sup> Totalcare Property Management is part of Totalcare Industries Limited which is a Territory Owned Corporation.

## **Current Procurement Methodology for Leasing Commercial Premises**

1.25 The steps now required to be taken when leasing commercial space for occupation by Territory agencies is comprehensive. The steps are summarised in diagram 1 on the following page. The process is managed by Totalcare Property Management.

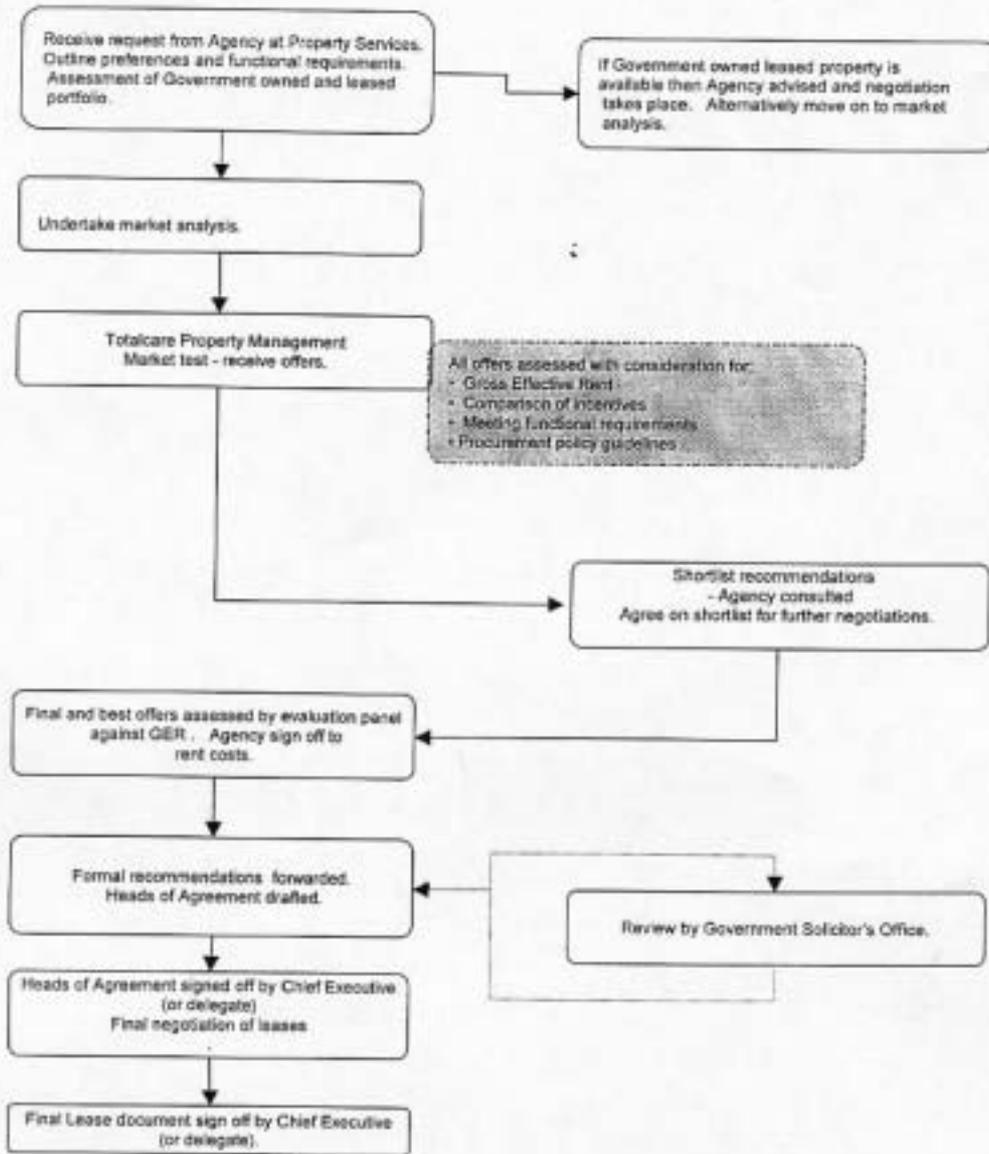
### ***Audit Comments***

1.26 Based on the available documentation it seems that few of the steps summarised in diagram 1 were followed in negotiating the rental rate to be paid by the Territory for occupancy of FAI House. In particular no market testing was undertaken.

1.27 On the information available to the audit the only conclusion that can be drawn is that, from the Territory's perspective, negotiation of the rental rates for the lease of FAI House was an inadequate process.

Diagram 1

Procurement Methodology for Leasing of Commercial Space on behalf of the Territory



## **ALLEGATION OF CONNECTION BETWEEN LEASE AND FAI CAR RALLY NAMING RIGHTS SPONSORSHIP**

### **Introduction**

1.28 There have been allegations made to the Audit that there was a connection between the higher rental rate agreed to be paid for the FAI House lease and the commitment by FAI to sponsor the 'Rally of Canberra' for four years commencing in 1996.

1.29 The sponsorship agreement provided for FAI to pay naming right sponsorship fees totalling \$1m for four annual rally events commencing with the 1996 event. The allegation was that higher than market rentals for FAI House were agreed to in order to recompense FAI for all or part of the sponsorship fees.

### **Available Documentation Does Not Support a Connection**

1.30 As previously stated in this Report there is little or no documentation available on the lease negotiations. There is also little documentation on the sponsorship negotiations. The documentation which has been examined by the Audit contains no evidence to support that a connection existed between the lease and the sponsorship.

### **Circumstantial Indications that a Connection May Exist**

1.31 The Audit is aware of two matters which could indicate a connection existed. These are firstly, the similarity in time when the two agreements were being negotiated and, secondly the urgent need the Territory had to find a naming rights sponsor for the Rally of Canberra.

1.32 *Timing Similarity of Agreements* – Based on the date of the facsimile referred to at paragraph 1.23 the rental rate for the lease of FAI House was agreed on or around 15 August 1996. The sponsorship agreement commenced on 18 September 1996. It therefore seems likely that negotiations for the lease rental rate and the sponsorship agreement would have been occurring during similar periods.

1.33 *Newspaper Article* – On 19 September 1996, which was the day after a public announcement was made by the Chief Minister that FAI would be the naming rights sponsor for the Rally, the Canberra Times

published an article with the headline 'Insurance Giant Emerges as Rally Saviour'. The article's first two paragraphs read:

A million-dollar, four-year sponsorship deal has confirmed the long-term future of the once-troubled Rally of Canberra.

The timely cash injection from FAI Insurance has given the three-day motor rally an enormous boost and eased pressure on the ACT Government, which had pledged to financially support the event to ensure it achieves Asia-Pacific Championship status in 1999.

1.34 The article illustrates the urgency which existed for the ACT Government to obtain a naming rights sponsor for the rally.

### *Audit Comments*

1.35 The similarity in the timing of the negotiations of the lease and the rally sponsorship is a circumstance which could support that there may have been a connection between the negotiation of the FAI House lease rental rate and FAI's agreement to be the naming rights sponsor for the Rally of Canberra. Also the Territory had an urgent need to find a sponsor and this could indicate that a motive existed for the Territory to enter into the type of arrangement alleged. There was however no documentary evidence available to the Audit that there was any connection between FAI's rally sponsorship and the lease of FAI House.

1.36 The Audit has decided it is unable to form an opinion on whether or not the allegation has any basis. This is because there is little documentation and the indicators of a connection are circumstantial.

## **CONCLUSION**

1.37 By the use of an independent valuer the Audit was able to obtain sufficient evidence to support an opinion that rental rates being paid by the Territory to occupy FAI House were excessive and continue to be so.

1.38 The Audit was able to form an opinion that the negotiation process from the Territory's perspective was inadequate. This was based on the higher than market rates negotiated combined with there being no evidence of market testing being undertaken or that any other practices were adopted to obtain data to inform the Territory's negotiation process.

1.39 Sparsity of documentation created significant difficulties for the Audit in drawing any definite conclusion on the final matter addressed in this Audit. In regard to the alleged connection between the higher lease rates and FAI's Rally sponsorship the Audit was unable to form an opinion.

### **CHIEF EXECUTIVES RESPONSES**

1.40 In accordance with section 18 of the *Auditor-General Act 1996*, final drafts of this report were provided to the Chief Executive of the Department of Urban Services and the Chief Minister's Department. The Chief Executive of the Department of Urban Services responded:

*I have no specific comment to make on the draft report except to note that the Property function was not within the Department of Urban Services at the time the lease was affected.*

1.41 The Chief Minister's Department Chief Executive responded:

*As this is a matter that comes more directly under the responsibility of the Department of Urban Services and as the report primarily deals with the facts of this matter, I have no comments to offer on the draft report.*

## **PREVIOUS AUDIT REPORTS<sup>3</sup>**

### ***Reports Published in 2003***

1. Effectiveness of Annual Reporting
2. Belconnen Indoor Aquatic Leisure Centre
3. Emergency Services
4. Management of Fraud and Corruption Prevention in the ACT Public Sector

### ***Reports Published in 2002***

1. Special Purpose Review of Part of the Commission of Audit Report on the State of the Territory's Finances at 31 October 2001
2. Operation of the Public Access to Government Contracts Act
3. Governance Arrangements of Selected Statutory Authorities
4. Frameworks for Internal Auditing in Territory Agencies
5. V8 Car Races in Canberra – Costs and Benefits
6. Annual Management Report for the Year Ended 30 June 2002
7. Financial Audits with Years Ending to 30 June 2002

### ***Reports Published in 2001***

1. Financial Audits with Years Ending to 30 June 2000
2. Enhancing Professionalism and Accountability
3. Market Research and Marketing (Second Report)
4. Peer-Based Drug Support Services Tender – 1998
5. The Administration of Payroll Tax
6. Annual Management Report for the Year Ended 30 June 2001
7. Managing Canberra Urban Parks and Open Spaces
8. Canberra Tourism and Events Corporation – Relocation to Brindabella Business Park
9. Agents Board – Financial Administration of Training Grant Program
10. Corrective Services – Review of Certain Allegations
11. Financial Audits with Years Ending to 30 June 2001
12. The Freedom of Information Act

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<sup>3</sup> 46 Reports were issued prior to 1996. Details can be obtained from the ACT Auditor-General's Office or the ACT Auditor-General's homepage: <http://www.audit.act.gov.au>.

### ***Reports Published in 2000***

1. Bruce Stadium Redevelopment — Summary Report
2. Bruce Stadium Redevelopment — Value for Money
3. Bruce Stadium Redevelopment — Costs and Benefits
4. Bruce Stadium Redevelopment — Decision to Redevelop the Stadium
5. Bruce Stadium Redevelopment — Selection of the Project Manager
6. Bruce Stadium Redevelopment — Financing Arrangements
7. Bruce Stadium Redevelopment — Stadium Financial Model
8. Bruce Stadium Redevelopment — Actual Costs and Cost Estimates
9. Bruce Stadium Redevelopment — Market Research and Marketing
10. Bruce Stadium Redevelopment — Stadium Hiring Agreements
11. Bruce Stadium Redevelopment — Lawfulness of Expenditure
12. Bruce Stadium Redevelopment — Governance and Management
13. Annual Management Report for the Year Ended 30 June 2000

### ***Reports Published in 1999***

- 1 Stamp Duty on Motor Vehicle Registrations
- 2 The Management of Year 2000 Risks
- 3 Annual Management Report for Year Ended 30 June 1999
- 4 Financial Audits With Years Ending to 30 June 1999

### ***Reports Published in 1998***

- 1 Management of Preschool Education
- 2 Lease Variation Charges - Follow-up Review
- 3 Major IT Projects - Follow-up Review
- 4 Annual Management Report for Year Ended 30 June 1998
- 5 Management of Housing Assistance
- 6 Assembly Members' Superannuation and Severance Payments to Former Members' Staffers
- 7 Magistrates Court Bail Processes
- 8 Territory Operating Losses and Financial Position
- 9 Financial Audits with Years Ending To 30 June 1998

- 10 Management of Schools Repairs and Maintenance
- 11 Overtime Payment To A Former Legislative Assembly Member's Staffer

***Reports Published in 1997***

- 1 Contracting Pool and Leisure Centres
- 2 Road and Streetlight Maintenance
- 3 1995-96 Territory Operating Loss
- 4 ACT Public Hospitals - Same Day Admissions  
Non Government Organisation - Audit of Potential Conflict of Interest
- 5 Management of Leave Liabilities
- 6 The Canberra Hospital Management's Salaried Specialists Private Practice
- 7 ACT Community Care - Disability Program and Community Nursing
- 8 Salaried Specialists' Use of Private Practice Privileges
- 9 Fleet Leasing Arrangements
- 10 Public Interest Disclosures - Lease Variation Charges and Corrective Services
- 11 Annual Management Report for Year Ended 30 June 1997
- 12 Financial Audits with Years Ending to 30 June 1997
- 13 Management of Nursing Services

***Reports Published in 1996***

1. Legislative Assembly Members – Superannuation Payments/Members' Staff – Allowances and Severance Payments
- 2 1995 Taxi Plates Auction
- 3 VMO Contracts
- 4 Land Joint Ventures
- 5 Management of Former Sheep Dip Sites
- 6 Collection of Court Fines
- 7 Annual Management Report For Year Ended 30 June 1996
- 8 Australian International Hotel School
- 9 ACT Cultural Development Funding Program
- 10 Implementation of 1994 Housing Review
- 11 Financial Audits with Years Ending to 30 June 1996

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