The Treasury

Budget 2017 Information Release

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: RNZ: Auckland building

Date:	26 July 2016	**Report No:**	T2016/1226
		File Number:	CM-1-3-66-1

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Agree** that joint Ministers will authorise a fiscally neutral capital to operating swap as a result of RNZ selling its Auckland property and returning the net sales proceeds to the Crown	12 August 2016
Minister of Broadcasting (Hon Amy Adams)	**Agree** that joint Ministers will authorise a fiscally neutral capital to operating swap as a result of RNZ selling its Auckland property and returning the net sales proceeds to the Crown	12 August 2016

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Juston Anderson	Principal Advisor, Commercial Advice	[39]	[23] (mob)	✓
Angela Graham	Manager, Commercial Advice	[39]	[23] (mob)	

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: No

Treasury Report: RNZ: Auckland building

Executive Summary

On 29 May Richard Griffin, the Chair of RNZ, advised the Minister of Broadcasting that RNZ was investigating selling its Auckland office building. We have been working with RNZ on the process for and implications of a sale.

RNZ intends to negotiate a sale and purchase of the property. It has already had unsolicited interest from a number of potential buyers. Assuming appropriate terms can be agreed:

- RNZ will remain in the property, leasing around 30% of the floor space, signing a long-term lease on standard commercial terms at market rates with the purchaser
- the purchaser will be responsible for remediation work on the property, which is leaky, at no cost or risk to RNZ, and
- RNZ will pay the Crown the net proceeds from the sale, estimated at around [25]

RNZ will take steps to ensure its position is protected, including ensuring it has an independent assessment of the fair market price for the property, and that any lease it signs with the purchaser contains appropriate commercial terms, for example that its operational requirements are not compromised when any new owner undertakes the remediation work on the building.

RNZ will also consult with the Office of Treaty Settlements to ensure there are no Treaty settlement implications from the proposed sale, although this seems unlikely. If there were, RNZ would be willing to offer the property for sale to OTS for landbanking, or to any interested iwi.

RNZ requests that its operating funding is increased, funded by the return of capital to the Crown, to offset the increase in its costs and loss of revenue associated with it becoming a tenant of the property rather than the owner.

Treasury supports RNZ's intention to sell the property, and its request for an increase in operating funding. The Crown is already incurring a cost from RNZ's ownership of the building. A sale by RNZ would simply change this from an implicit economic cost to an explicit operating cost, while benefitting the Crown by freeing up capital.

An increase in RNZ's funding can be implemented through a fiscally neutral capital to operating swap, which can be approved by joint Ministers under Cabinet Office circular CO(15)4. The circular states that "the total sum of capital must cover ten years of the proposed operating expenses" for a swap to be fiscally neutral. Consistent with this, assuming the net sales proceeds and capital returned to the Crown is [25] we will recommend joint Ministers approve an ongoing fiscally neutral increase in RNZ's funding of [25]

RNZ needs an indication from Ministers that you are willing to support this fiscally neutral swap so that it can proceed with negotiating the sale with potential buyers. Without this, a sale of the building would likely leave RNZ worse off, and so it would be risky to proceed.

RNZ requests that $4.12m of the proceeds are used to redeem its preference shares. We support this request, as this is the type of situation the preference shares were intended for. For the Crown, the redemption of the preference shares is no different to a return of capital, so does not affect the fiscal neutrality of the proposed capital to operating swap.

In our view, RNZ should be commended for focusing on its core responsibilities, improving the efficiency of its balance sheet and returning surplus capital to the Crown.

The Ministry for Culture and Heritage was consulted on the contents of this report and agrees with its recommendations.

Recommended Action

We recommend that you:

a **note** that RNZ intends to sell its Auckland office building and enter into a long term lease with the new owner for around 30% of the space in the building, which it requires for its ongoing operations

b **note** that RNZ has decided to return the net proceeds from the sale of the building to the Crown, which it estimates will be around [25]

c **note** that selling the building is an operational decision for RNZ that does not require approval by Ministers, but once it sells the building, RNZ's operating expenses will increase (due to the need to pay rent to the new owner, and its income from leasing space in the building will cease), and that RNZ requests an increase in its operating funding to reflect this

d **note** that the Treasury supports an increase in RNZ's funding, which can be accommodated by a fiscally neutral capital to operating swap, consistent with Cabinet Office circular CO(15)4, where joint Ministers can approve an ongoing increase in RNZ's funding of $1 a year for every $10 of capital returned to the Crown by RNZ, i.e. an estimated [25] a year (around a [25] if sales proceeds are [25]

e **agree** that joint Ministers will authorise the necessary fiscally neutral capital to operating swap in recommendation (d) above either in the next baseline update or by letter, after the sale has been completed and the amount of capital returned to the Crown has been confirmed

Agree/disagree.	*Agree/disagree.*
Minister of Finance	*Minister of Broadcasting*

f **note** that RNZ proposes that $4.12m of the capital returned to the Crown should be applied to redeeming RNZ's preference shares, that the Treasury supports this proposal, and that we will report to shareholding Ministers with the necessary documents to redeem the preference shares after the sale has been completed

Angela Graham
Manager, Commercial Advice

Hon Bill English	Hon Amy Adams
Minister of Finance	**Minister of Broadcasting**

Treasury Report: RNZ: Auckland building

Purpose of Report

1. This report is to brief Ministers on RNZ's intention to sell its Auckland building and return the proceeds to the Crown, a proposed fiscally neutral capital/operating swap for RNZ as a result of the sale, and the proposed redemption of RNZ's preference shares.

Background

2. RNZ purchased the property, in Hobson Street in Auckland, in November 2004 at a cost of $7.5m. It appears the government at the time provided $3.75m of new equity to RNZ to part-fund the purchase.

3. The four-storey building (plus one level of basement car parking) has a floorspace of around 3,300m^2 of which RNZ currently occupies around 1,240m^2 or 30%. Some of the remaining space is leased to various tenants, but around 25% is currently vacant. The building includes 36 carparks, of which 12 are used by RNZ, [25]

4. RNZ has identified that the building is leaking. The necessary repairs are estimated to cost up to [25]

5. It appears the leaks have been caused by a combination of:

   - a refurbishment of the property in 2004 (presumably, pre-RNZ's purchase) including recladding and new windows, but which did not make any changes to the rear of the building – the area that is now leaking
   - a lack of appropriate maintenance by RNZ, e.g. no regular repainting, which is an integral component of waterproofing the non-refurbished cladding, and
   - various alterations to the exterior of the building for tenants, which have compromised its water tightness e.g. installation of ventilation for a ground-floor cookery school.

Options considered by RNZ

6. The first choice for RNZ was whether to remain in the building or to move.

7. Moving is not RNZ's preferred option, at least in the medium term, as the space RNZ occupies has around [25] of specialised fit out and equipment installed, e.g. soundproof studios. This would be time-consuming and expensive to relocate.

8. Given this, RNZ has three choices:

   a. remain the owner of the building, and therefore repair the leaks itself (doing nothing is not an option)

   b. repair the building and then sell it, while remaining as a tenant of the space it requires

   c. sell the building as-is, with repairs being the new owner's responsibility, while remaining a tenant

9. RNZ's view is that selling the building is the preferred option, as property ownership is not RNZ's core business. RNZ has also rejected the option of contracting for the repairs itself, on the grounds of the risks involved and its lack of expertise. This leaves selling the building as-is, option (c), as its preferred choice.

10. RNZ will take steps to ensure its position is protected, including ensuring it has an independent assessment of the fair market price for the property, and that any lease it signs contains standard commercial terms, for example that its operational requirements are not compromised when any new owner undertakes the remediation work on the building.

Treaty implications

11. The property does not have any Treaty-related rights of first refusal over it. RNZ will discuss the proposed sale with the Office of Treaty Settlements to see if it, or any relevant iwi, are likely to have any interest in the property (although this seems unlikely).

Proceeds and funding implications

12. RNZ proposes to return the net proceeds of the sale to the Crown as a special dividend. It estimates this will be around [25]

13. Once it sells the building, RNZ will lose the income it is receiving from leasing some of the space. It will also need to start paying a market rental to the new owner. However, it will also no longer have to pay the various costs of ownership (e.g. rates).

14. The net impact will be an increase in RNZ's costs. This is discussed in detail below. RNZ requests an increase in its operating funding from the Crown to reflect this.

Treasury's view

15. From the Crown's perspective there has always been an economic cost associated with RNZ's ownership of the building, due to the capital invested in it. It is clear that this capital has not been generating a good return for the Crown, given that RNZ currently only occupies around 30% of the building, that a significant percentage of the remainder is vacant, and that the costs involved in repairing the leaks to the building are at least partly due to a lack of regular maintenance by RNZ in the past.

16. We agree with RNZ that property ownership is not its core business. Therefore we also agree that a sale is the preferred option. The Crown will be better off as a result, even after a fiscally neutral increase in RNZ's ongoing operational funding, due to the capital freed up which can be reallocated to other uses, and the better management of the building by an owner with the appropriate skills and incentives.

17. We also agree that a sale before repairing the building is preferable. While repairing the building first might increase net sales proceeds, it would expose RNZ (and the Crown) to the uncertainties and risks involved in the repairs. A buyer of the building will be better placed to manage these risks.

18. We support RNZ's request for an increase in its operating funding. The increase will be fiscally neutral and can be approved by joint Ministers under Cabinet Office circular CO(15)4.

19. CO(15)4 states that “the total sum of capital must cover ten years of the proposed operating expenses” for a swap to be fiscally neutral. Consistent with this, and assuming the net sales proceeds returned to the Crown are [25] we will recommend joint Ministers approve a fiscally neutral increase in RNZ’s ongoing operating funding of [25] The final figures will be confirmed once RNZ has completed the sale.

Impact on RNZ

20. The proposed capital to operating swap should result in a small improvement in RNZ’s operating surplus (all else equal). The rent RNZ will pay on the building, plus the lost income from leasing some of the space to other tenants, should be slightly less than the increase in its funding (assuming sales proceeds are around [25] and so the fiscally neutral capital to operating swap is around [25] . A significant factor in this is that around 25% of the building is currently vacant and not generating any rent for RNZ.

21. A report to RNZ from external property advisers dated October 2015 estimated the market rent on the floors that RNZ is occupying to be around [25] . If RNZ negotiated a lease at around this rate for space it currently occupies, it would pay around [25] a year. RNZ may be able to negotiate a lower rent than this for signing a long-term lease. RNZ would also rent a small number of carparks for staff, basement storage space, and space for an emergency generator, which collectively would add perhaps another [25] , for a total cost of renting of [25]

22. Conceptually, the Crown is already incurring an economic cost of around [25] to [25] a year from RNZ’s occupation of its space in the building. RNZ’s sale of the building would simply change this from an implicit economic cost to an explicit operating cost.

23. There will also be a number of other costs or lost revenue for RNZ after it sells the building:

- rental income from the existing tenants in the building will no longer be received
- ownership expenses (e.g. rates) that are not directly passed on to tenants will no longer be incurred, and
- a depreciation expense will need to be incurred on RNZ’s specialised fit out and equipment installed in the building, which it would retain ownership of[1]

24. While some of these figures will depend on negotiations with the purchaser, RNZ estimates (and we agree) there would effectively be a net increase of around [25] to [25] in RNZ’s funding as a result of the transaction, assuming Ministers approved the fiscally neutral capital to operating swap. This would consist of a [25] funding increase, less [25] of increased costs and reduced revenue. This is a net increase of less than [25] even at the high end of the range.

25. RNZ will also have to consider the potential for its rent to increase in the future, depending on the term of the lease and what provisions it includes for rent reviews.

The cost of vacant space in the building

26. A report to RNZ from external property advisers dated October 2015 estimated the net rental income from the building could increase by around [25] if all vacant space was occupied (including car parks). There would be a further small increase if existing rentals were brought up to current market rates, although this would take time as existing contracts would need to roll off.

[1] Currently the fitout is included in the building rather than depreciated as a separate asset

27. This [25] of potential rent not currently being earned by RNZ is also an economic cost to the Crown. Selling the building transfers that cost to the new owner.

Should RNZ's operating position improve?

28. It would be possible to set the increase in RNZ's operating funding to be exactly the same as the net increase in its costs and loss of rental income. This would leave RNZ's operating surplus unchanged. It would also mean that the transaction was fiscally positive for the Crown.

29. We do not recommend this because it would:

- not be consistent with Cabinet Office circular CO(15)4, and with the approach taken for other capital to operating swaps
- not give RNZ an incentive to improve the efficiency of its balance sheet (this is one of the reasons why CO(15)4 allows fiscally neutral capital to operating swaps on a 10 to 1 ratio)
- set a poor precedent for other entities considering similar transactions
- require Ministers and officials to become involved in a level of detail regarding RNZ's costs that would normally be left to the board and management, and
- pragmatically, most likely make little difference (perhaps [25] a year)

Do Ministers need to make a decision now?

30. Ministers could defer a decision on any increase in RNZ's operating funding until the sale of the building was completed and we had confirmed figures for the net sales proceeds, the rental RNZ will have to pay, and the other impacts on its costs and revenues.

31. However this would leave RNZ in a difficult position. If it goes ahead with a sale on the building and returns the proceeds to the Crown, but does not receive an increase in its operating funding, it will likely be worse off than its current position.

32. Even if RNZ retained the net sales proceeds rather than returning them to the Crown, it would still be worse off given current interest rates. At say [25] for a one-year term deposit the interest income on [25] would be around [25] a year. And in any case from the Crown's perspective this would be a highly inefficient use of capital. RNZ may also be concerned that the Crown would require it to return some or all of the net proceeds.

33. So it would be risky for RNZ to proceed with a sale given uncertainty around the impact on its operating funding from the Crown. Since we think a sale is good for both RNZ and the Crown, we recommend that Ministers address this, by agreeing that you will authorise a fiscally neutral capital to operating swap for RNZ, with the exact amounts to be consistent with CO(15)4, to be confirmed once the sale is completed.

34. Alternatively, if Ministers do not wish to agree to a fiscally neutral capital to operating swap, or if you have any concerns with the proposed sale, RNZ should be told now, so that it can either address the concerns, or stop investigating the sale.

Preference shares

35. The Crown holds $4.12m of redeemable preference shares in RNZ. The shares were created when RNZ was corporatised in the mid-1990s. They were intended to give the Crown the option of a return of funds from RNZ, if at some point in the future its financial position allowed.

36. Unlike ordinary shares, RNZ's preference shares carry an entitlement to an annual dividend at a rate of the government stock yield plus 1%, and are redeemable on 30 days' notice from shareholding Ministers to RNZ. Since RNZ's financial position has not allowed it to pay a dividend or redeem the preference shares, each year since the mid-1990s Ministers have had to waive their right to the dividend, and to confirm that they will not require redemption.

37. The sale of RNZ's Hobson Street property is the type of situation the preference shares were intended for. The preference shares give Ministers the option of requiring RNZ to pay the proceeds of a sale to the Crown (up to the amount of the preference shares, $4.12m). However this is not necessary, as RNZ has already decided to pay the full net proceeds to the Crown.

38. We agree with RNZ that part of sales proceeds should be applied to redeeming the preference shares. From the Crown's perspective, there is no difference between RNZ paying a special dividend from the sales proceeds, or redeeming the preference shares. Both result in cash being returned to the Crown, which offsets the increase in RNZ's operating funding.

Broader implications

RNZ strategy

39. RNZ believes its emphasis should be on achieving its content and audience objectives, as articulated by the charter, and that it should minimise its investment in infrastructure and non-core assets. The sale of the Auckland property is the first step towards this. This approach seems sensible, as long as RNZ can ensure that its operational capability is not diminished.

[25] [33] [37] [38]

RNZ funding

41. RNZ advises that it plans to engage with the Minister of Broadcasting and officials later this year, and then submit a proposal for an increase in its Crown funding as part of Budget 2017.

42. Therefore the fiscally neutral capital to operating swap should not be seen as a substitute for a further consideration of RNZ's ongoing funding needs. However, the sale of the Auckland building is evidence that RNZ is working to improve the efficiency of its balance sheet and to return surplus capital to the Crown – and as such, provides support to a future request for funding.