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- What follows is my summary and expert opinion about the Kensington Evaluation report of 2012.

Initial aims of this aspect of the evaluation

The Kensington report discusses the financial structure of the redevelopment. The aim of this aspect of the evaluation was to assess the up-front costs of the redevelopment.

A key aim was to employ, if possible, a Public Sector Comparator (PSC) methodology.

Public Service Comparator compares the c*cost of the public-private or public private delivery* of the redevelopment with the likely cost if it were *delivered fully by the public sector.*

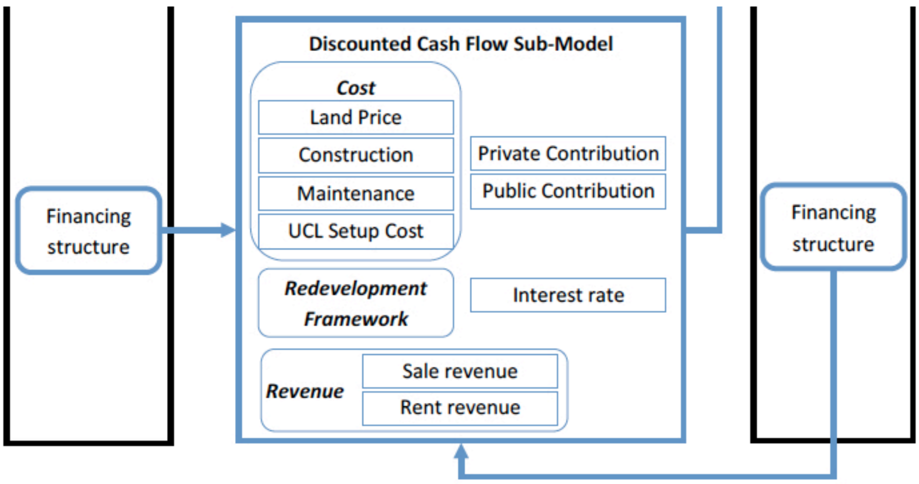

Diagram of financial analysis framework

- At the time the redevelopment of Kensington estate was one of the largest public and private joint partnerships or privatisation programs (not strictly a PPP) to deliver public housing in Australia.

- Many of these joint partnerships are complex and bespoke arrangements are often made reflecting the type of project, the parties involved, the particular form of procurement adopted, market conditions including the availability of finance.

Description of the development in financial terms

The diagram indicates the complexity of the redevelopment and how its financial structure changed over time. It describes in particular the flow of funds from DHS for demolitions and relocations, from

DHS to Becton for design and construction, and from Becton to DHS for land sales, as well as the evolution of KMC to UCL in financial terms.

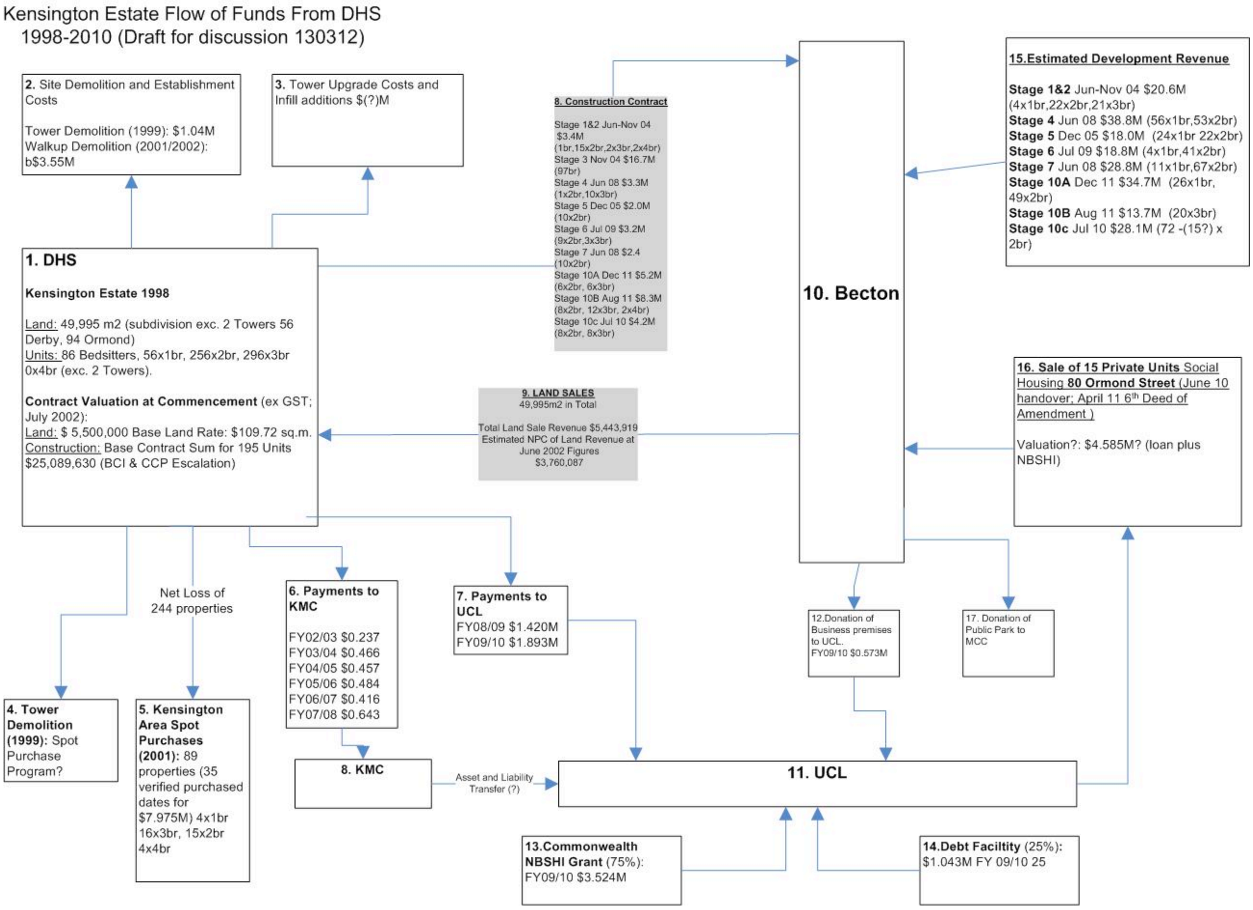

Figure. Financial Flow of Funds and Assets

Data issues

As indicated in the recent Victorian Auditor General's report (2012) there has not been a systematic approach in DHS to gathering quantitative data for measuring, comparing or modelling quantitative housing outcomes.

Data

- The lack of available data affected the analysis in a number of respects. These include the lack of comparative historical data regarding operational expenditure, for Kensington or other DHS sites.

- Another issue is the fuzziness and ambiguity of data related to the numbers of units at Kensington and other sites.

- Commercial-in-confidence provisions also limited the amount of data available. This includes lack of readily available and detailed data for different UCL business units for example, the number and types of units under management at any given time.

Table: Availability of data and impact on the finance analysis.

Data Item	Received	Impact
Land price	Provided in the contract and provided by DHS as a final figure. But only partial data provided from DHS for the sale of Land to Becton. A number of valuation reports regarding the land valuations were completed but these were not provided by DHS or Becton.	Timing of the cash flows from the land sales has been assumed to take place on construction handover dates (more data required). What about the actual valuations? Some comment?
Construction costs	Provided by both DHS and Becton.	These differ between: the cost to construct for Becton (from figures provided by Becton) and the amount paid by DHS to Becton (from figures provided by DHS).
Maintenance costs and tenancy management costs	Very little historical data has been received from DHS regarding the amount spent on maintenance on the Kensington estate.	This prevents a full PSC being undertaken. Annual cost of maintenance per unit in 2001/2002 would have enabled this. Further data, or comparable data for the Kensington estate prior to 2002 is required. Ideally, spend per unit data would be adequate. (More data required).
UCL set up costs	These have been provided.	While provided it is still difficult to ascertain how these impact on UCL's financial efficiency. Data from Becton outlining the value of Becton's contribution to the project is required. (See private contribution below).
Interest rate	The land escalation rate and construction index rates have been provided.	These have been accounted for.
Sales revenue	Provided by Becton	Only estimated sales figure have been provided. Only further data from Becton or further research outside of the scope of the study would confirm the accuracy of these figures.
Developer contribution	No data provided by Becton for its contributions to the project.	These are difficult to ascertain. But might include the donation of the UCL offices and other expenses incurred by Becton related to community building. (More data required).
Rent revenues	Not provided by DHS in relation to the Kensington estate.	Without historical rent revenues a full PSC cannot be constructed. Rental data for Kensington estate prior to 2001/2002 is required.

- Further, the commercial-in-confidence data from the developer Becton was such that its accuracy could not therefore be verified. It is possible that this data overstates the cost of the units to build and understates the revenues to Becton as a result of their sale.

- Nevertheless, the data provided by Becton was taken on face value in the analysis.

- These issues contrasted strongly to the Bonnyrigg in NSW project where a comprehensive PSC was calculated and published in 2006.

- A table in the chapter summarises the availability, or lack of, data and the impact of this on analysis of the finance mix. Where more data would significantly improve the analysis, this is noted.

Land valuation issues

- The research team had access to some of the sale of land contract files archived at DHS. These provided only partial information for a number of these lots for land sales settled at various times from 2002 to 2009.

- Several valuations appear to have been completed regarding the value of the land. One valuation by Arthur Anderson dated October 2000 valued the land at $9,250,000 (sighted once). Another in the archived file by O'Brien's outlines two scenarios: at $10,000,000 and another at $5,500,000.

The Mix : History of the development and its financial structure

- The rationale for the 30-70 mix appears to have come out of a series of qualitative consultancy reports prepared for the Kensington Estate Redevelopment Advisory Committee in 1999.

- This mix, once determined, formed a key element of the redevelopment's financial structure.

- No alternative quantitative forecasts appear to have been undertaken regarding the initial proposal for a 30-70 mix of new-build public and private housing units.

- In other words it appears that prior to tender no quantitative business case was prepared to explore the implications of this mix for the cash flows and risk profile of the project.

- In any case, the project was tendered and then contracted on a 30:70 public-private mix, which as stated elsewhere in the report led to a net loss of 176 units of public housing (taking into account the 89 replacement spot purchases).

Table: Assumptions employed in the quantitative analysis

PSC Item	Cost Element	Assumptions
Direct Capital Costs	Pre-Design/Feasibility	Not included as DHS historical data unavailable
	Land Valuation	Valued in contract at 5,500,000 \$109.72 m2 Survey 15/03/2001 49,995.00m2
	Relocations	Based on DHS data. Purchases 1,691,000 and Works 356,000 for 89 Properties
	Building Price Index	Melb June 2000 116.12 to Melbourne June 2001 120.76 escalation 4.64 say 4 percent
	Demolition	Tower Demolition (1999): \$1.04M Walk-up Demolition (2001/2002): \$3.55M
	Design and Construct Costs	Design and construct costs used in the forecast valuation are based on Rawlinson cost data for 2002. This suggest a range of m^2 for multi storey flats medium standard as \$1455 and 3 storey flats as \$1205. The \$1455 figure has been used
	Consultants	10 percent for all consultants including architectural, without further data and information from DHS it is difficult to know what to include for this. The final consultant cost was much less. But it is reasonable to assume in the PSC construction as it could reasonably include all consulting and project management costs
	Plant and Equip	Included in design and construction cost
	Capital Improvements	Not included as DHS historical data unavailable
	Through Life Capex	Not included as DHS historical data unavailable
	Construction Overheads	Included in design and construction cost
Maintenance Costs		Not included as DHS data unavailable maintenance and repairs on buildings: based on 2001 DHS KMC data
Direct Operating Costs	Wages and Salaries Running Costs Insurance	Not included as DHS data unavailable

Indirect Operating Costs	Construction Overheads	Assumed this is in the design and construction price. Not included as DHS data unavailable
	Operating Overheads	Not included as DHS data unavailable
	Administrative Overheads	Not included as DHS data unavailable
Competitive Neutrality (not applied)	Land Tax	54,880 plus 5.0 percent for each dollar over $2,700,000
	Local Govt Rates	5 percent of property value = NAV And then 6.5 per cent of NAV (2001-2002 MCC figure)
	Stamp Duty	5.5 percent over 870,000 (SRO current rates 2002)
	Payroll tax	1 Jul 2002 to 30 Jun 2003 $550,000 $45,833 5.35 percent
Timing of Cash Flows		Assume all dates start from signing of DA in June 02 (signed July 02). But the estimated timing of stages and cash flows is as per the Development Program in the Development Agreement
Nominal Discount Rate N= (1+r) times (1+i)-1		In this instance the risk free rate is taken as 5.0 percent and inflation at 2.5 percent. This gives a nominal discount rate of 8.75 percent for the reference project

A Net Present Cost Analysis using a Public Sector Comparator

Using the PSC methodology cash flows were discounted back to June 2002. This was in order to answer the question:

What is the NPC, or difference, between a PSC prediction of the design and construction costs, the winning bid design and construction price, and the actual design and construction costs?

A full PSC evaluation could not be constructed because of the lack of historical data on the amount DHS spends to maintain each housing unit per annum. Nevertheless, a partial or *"forensic"* PSC evaluation was completed.

A risk free rate of 4.95 percent and an inflation rate of 2.5 percent was used in the analysis. At the time this was in line with the Partnerships Victoria guidelines as per the *Partnerships Victoria Technical Note 2* and the table entitled Risk Free Rate and Market Risk Premium found in Annexure 3 *Discount Rate Inputs for Partnerships Victoria Projects*.

Net Present Cost (NPC) scenario analysis

Based on the assumptions outlined in the chapter a number of different NPC scenarios were modelled.

Read out the Scenarios <u>(Total Costs include Demolition and Relocations)</u>

Table: Scenario Analysis Describing Total Net Present Costs (NPC)

Public Private Mix Scenarios (based on proposed numbers at or just prior to DA signoff).	**Total NPC to DHS at June 2002** (Total Costs include Demolition and Relocations)
<u>Scenario 1</u> **30 percent public : 70 percent private**	NPC: $41,120,599 Unit Cost: $210,875
<u>Scenario 2</u> **50 percent public : 50 percent private**	NPC: $49,677,857 Unit Cost: $161,292
<u>Scenario 3</u> **100 percent public**	NPC: $82,175,038 Unit Cost: $133,401
<u>Scenario 4</u> **Base Land Value Increased to 10,000,000 with a 30 public 70 private mix**	NPC: $38,483,651 Unit Cost: $197,352

- In 2002 dollars: increasing the public-private mix to 50:50 would have the effect of increasing the project cost to the public by $9.46M, but would have reduced the cost per unit to $161,292. This is because of the potentially much lesser cost for relocations purchased through the spot purchase program.

- Scenario 3 simulates what would happen if the estate was redeveloped as 100% public and all of the tenants were moved from the estate and then moved back.

- Scenario 4 where the land value is doubled reduces the cost of the project to DHS. But as suggested above this would correspondingly reduce the profit margin (and the IRR to a developer).

- The Net Present Cost (NPC) scenario 2 analysis indicates that increasing the number of units to 50 percent for the redevelopment of the site (excluding the towers) could have been done at a relatively low additional or marginal cost to DHS. All of the existing tenants of the original estate needed to be relocated but only 30% were placed back into the estate.

<u>A key point was that: In future redevelopments, the above scenarios indicate the need for DHS to model at an early stage different outcomes that account for construction costs, relocation costs, relocation logisitics and the impact of these on optimised public and private housing mix.</u>

Value for Money Comparative Quantitative Analysis

Table: Comparison of Predicted Net Present Cost (NPC)/Actual Tender Bid Cost/ and Actual Final Cost (in June 2002 Dollars).

Total Cost to DHS for Private Units (June 2002 $ Amounts)	**NPC Prediction**	**Tender/ DA Agreement**	**Actual Final Costs** (in June 2002 $ Amount. Allowing for compensation and consultant costs)
Normalised	1.00	1.093	1.197
NPC D&C Cost	Total: 22,950,569 Per Unit: 117,695	Total: 25,089, 630 Per Unit: 128,665	Total: 27,493,127 Per Unit: 140,995
Cost of Demolition (Assuming at time zero)	4,590,000	4,590,000	4,590,000
Cost of (Relocation Purchases and Works)	17,266,000	17,266,000	17,266,000
Sub Total Costs to DHS	44,806,569	46,945,630	49,349,127
NPC of Land Revenue to DHS	3,685,970	3,685,970 (Assumes timing is same as for NPC Prediction)	Land: 3,760,087
Total Cost to DHS	**Total: 41,120, 599** **Per Unit: 210,875**	**Total: 43,259,660** **Per Unit: 221,844**	**Total: 45,589,040** **Per Unit: 215,042**
Nos. of Public Units.	195	195	212

- According to the above table the contract price received from Becton was within 10 percent (1.093) of our estimated design and construction cost NPC for the project. This is an acceptable outcome and indicates the original tender price was probably competitive.

Developer Profit

- The following table indicates an estimate of profits made from the project. The average net profit margin across the project is 37.56 percent.

- The analysis indicates that the final stage of the project has an estimated net profit margin of 51 percent.

- It is possible that the actual profit was higher. This analysis is based on the data matrix provided to the research team by the developer.

Table: Estimation of Profits to Developer.

Estimated profits to developer	June 2002 $Dollars
Cost to developer	74,614,697
Revenue to developer	119,494,679
Profit	44,879,982
Profit Margin	37.56 percent
Cost/Unit	145,732
Profit/Unit	87,656

Overall Numbers

Overall Numbers: Prior to the redevelopment, the estate had 694 old and deteriorated public units in three high-rise towers and 18 walk-ups. One tower and all the walk-ups, containing 491 units in total, were demolished. DHS bought 205 new-built units and gained another 21 through additions and conversions. **Hence total of 265 public units were lost from the estate.** The financial analysis for the redevelopment does not take into account the net loss of public housing units in well located areas, restricting a full value for money assessment.

Conclusion (what is the bottom line?)

Does the redevelopment model represent value for money for the taxpayer in quantitative terms.

- **Overall:** The project generally proceeded on budget with a minimal cost overrun to DHS. On this basis the project does represent cost effectiveness to DHS. However, a range of hidden or missing costs to DHS in the development are either hard to estimate or were generally unaccounted for.

- There were three land valuations for component of the estate that was sold by DHS to the developer. One of these valued the land at $10,000,000 in 2002. A second valued it at $9,250,000, and a third at $5,500,000. It appears that DHS actually received $3,760,087 in June 2002 dollars. On face value, this does not appear to represent value for money.

- Our estimate of the total cost to DHS of the demolitions, relocations and purchase of the new-build (but not including the additions and conversions) is 45,589,040 in June 2002 Dollars. This amounts to $215,042 per unit. This is a reasonable price, given market conditions, and represents cost-effectiveness for the state. **But It does not take into account the loss of 265 public housing units in inner city area with high amenity, nor the costs of housing an equivalent number of households elsewhere.**

- The 30:70 public to private mix is not specifically justified anywhere and represents a significant advantage to the developer. The profit to the developer was estimated by us to be $44,879,982 in June 2002 Dollars. This figure may be under-estimated. It is reasonable for the taxpayer to expect that such use of inner-city public land should generate a return for both developer and the state.

- The approval of 57 additional private units in stage 10 which added significantly to developer profit but with no benefit to the state, and possibly to the detriment of the residents of the estate, is completely unexplained.

- At the time, the anticipated return to the developer appeared commensurate with the untested and possible high risk nature of the redevelopment. As it turned out, the project was lower risk than would be now currently accepted. In the future, lower risk should be equated with lower return to the developer, and higher return to the state in exchange for the sale of public land.

- Given the estimate of the developers profit at a minimum average of 37 percent it is suggested that in future inner-city estate redevelopments, a profit share arrangement be considered by DHS.

- It was concluded that reasonable to suggest that future developments consider increasing the proportion of public housing. The impact of the 30:70 public-private mix on cash flows to both the private and public stakeholders was not quantitatively examined by DHS. At Kensington the rationale for this mix appears to be based on qualitative data alone.