



Security Level: IN CONFIDENCE

Date: 18 July 2016

Report to: Minister of Finance
Minister of State Services
Minister for Primary Industries

HEAD OFFICE ACCOMMODATION FINAL COMMERCIAL TERMS – MINISTRY FOR PRIMARY INDUSTRIES

Purpose of the Report

The purpose of this paper is to report back on the final commercial terms negotiated for the Ministry for Primary Industries' head office accommodation solution, approve funding from the tagged contingency, and seek authority for the Director General of the Ministry for Primary Industries to execute the Development Agreement, Deed of Lease, Deed of Assignment and Deed of Partial Surrender and Variation of Lease, as well as an Agreement to Lease and Agreement to Assign Lease for their temporary decant premises. The Business Case and procurement process was led by the Government Property Group, working closely with Ministry for Primary Industries' staff.

Recommended Actions

We recommend that you:

1. **Note** that the Government Property Group (GPG), supported by Ministry for Primary Industries (MPI), has negotiated a Development Agreement, Deed of Lease, Deed of Assignment and Deed of Partial Surrender and Variation of Lease, as well as an Agreement to Lease and Agreement to Assign Lease for their temporary decant premises (Suite of Legal Documents) for its Wellington head office accommodation solution.
2. **Note** that authority to agree to the final investment decision for this solution was delegated to Joint Ministers (Minister of Finance and Minister of State Services) by Cabinet on 2 June 2015 (CAB Min (15) 18/7 refers).
3. **Note** that the negotiated accommodation solution offers a building with high levels of safety and standards that provide good staff protection and mitigate risk to business continuity.
4. **Note** that the Crown's legal services provider has certified that the Suite of Legal Documents reflect the agreements reached between the parties during the negotiations and, accordingly, are in order for execution.
5. **Note** that there are commercial imperatives in having the lease signed by 29 July 2016.
6. **Approve** the final commercial terms of the Suite of Legal Documents negotiated for MPI's Wellington head office accommodation solution

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7. **Approve** the following changes to appropriations and capital injections to the Ministry for Primary Industries to give effect to the decision in recommendation 6 above, with a corresponding impact on the operating balance and debt:

Vote Primary Industries and Food Safety Minister for Primary Industries	\$m – increase/(decrease)				2020/21 & Outyears
	2016/17	2017/18	2018/19	2019/20	
Multi-Category Expenses and Capital Expenditure:					
Border and Domestic Biosecurity Risk Management MCA					
Departmental Output Expense:					
Border Biosecurity Monitoring and Clearance (funded by revenue crown)	1.407	2.317	1.157	1.146	1.146
(funded by revenue other)	1.241	1.480	0.760	0.771	0.771
Ministry for Primary Industries: Capital Injection	s 9(2)(j)		-	-	-
Total Operating	2.648	3.797	1.917	1.917	1.917
Total Capital	s 9(2)(j)				

8. **Agree** that the proposed changes to appropriations and capital injection for 2016/17 above be included in the 2016/17 Supplementary Estimates and that, in the interim, the increases be met from Imprest Supply;
9. **Agree** that the expenses and capital expenditure incurred under recommendation 7 above be charges, respectively, against the tagged operating and capital contingencies for WAP2, established as part of Budget 2016.
10. **Note** that the costs of MPI's head office are spread across all MPI departmental appropriations, and that the funding in recommendation 7 above will be spread across appropriations at a future baseline update process.
11. **Note** that the capital figures included above include a contingency of s 9(2)(j) on the base build costs, and that professional advice received by MPI was to include a s 9(2)(j) contingency at this early stage of design. Once detailed design and pricing is completed it may be necessary to seek additional funding from the WAP2 tagged contingency.
12. **Note** that in addition to the lower than optimal level of contingency, there are risks associated with elements of the Development Agreement that could potentially expose MPI to increased costs, namely detailed specification of the landlord's works. These works will not be specified for some months and MPI may need to seek up to s 9(2)(j) from the tagged capital contingency established in Budget 2016 to enable the building to be delivered to an acceptable standard (which will be at MPI's costs), should these risks eventuate.
13. **Agree** that any of the operating and capital funding increases in recommendation 7 above not required by MPI for WAP2 purposes (e.g. because of lower-than-anticipated decant or fit-out costs, or reduction in applicable capital charge rate) be returned to the WAP2 tagged operating and capital contingencies, respectively, to help provide for costs pressures faced by other WAP2 participating agencies.
14. **Delegate** to the Director General of MPI the authority to execute the final commercial terms of the Suite of Legal Documents negotiated for MPI's Wellington head office accommodation solution

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Agree/disagree
Hon Bill English
Minister of Finance

Agree/disagree
Hon Paula Bennett
Minister of State Services

Signed: _____
Date: _____

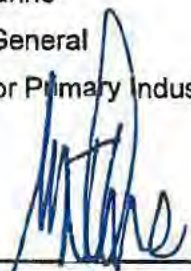
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Date: _____

Agree/disagree
Hon Nathan Guy
Minister for Primary Industries

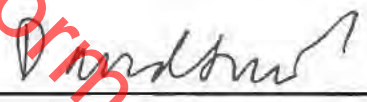
Signed: _____
Date: _____

Endorsed by:

Martyn Dunne
Director-General
Ministry for Primary Industries

Signed:  _____
Date: 19.7.16

David Smol
Chief Executive
Ministry of Business, Innovation
and Employment

Signed:  _____
Date: 25.7.16

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Agree/disagree

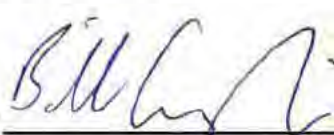
Hon Bill English

Minister of Finance

Agree/disagree

Hon Paula Bennett

Minister of State Services

Signed: 

Date: 26/7/2016

Signed: _____

Date: _____

Agree/disagree

Hon Nathan Guy

Minister for Primary Industries

Signed: _____


Date: _____

Endorsed by:

Martyn Dunne

Director-General

Ministry for Primary Industries

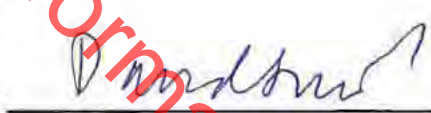
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Minister of Finance

Agree/disagree
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Executive Summary

1. MPI participated in a collective head office accommodation business case during 2015 as it has a lease term due to expire in the Wellington Central Business District (WCBD) on 31 March 2017 for the majority of their building, and a lease expiry on 31 January 2018 for one other floor. The Business Case was prepared by the Property Management Centre of Expertise hosted at the Ministry of Social Development (MSD)¹, pursuant to the functional leadership mandate delegated from the State Services Commissioner to the Chief Executive of MSD.
2. A preferred solution for the 24 participating agencies of the Wellington Accommodation Project Tranche 2 (WAP 2) was approved by Cabinet on 2 June 2015. MPI was identified to remain in situ at 25 The Terrace (Pastoral House). GPG led the negotiation for Pastoral House and was supported by MPI, a Tenant Advocate (specialist property negotiator) and other external technical services such as legal and engineering.
3. As part of the Development Agreement, the landlord will be undertaking a refurbishment programme at the Landlord's cost which will include the following:
 - seismic strengthening works
 - additional seismic restraint of non-structural elements
 - a new building entrance on The Terrace
 - lift refurbishment and the installation of a destination control system
 - shower, toilet and locker room refurbishment
 - installation of new carpet throughout the premises
 - re-commissioning and enhancement of all air conditioning and other building systems to cope with greater densities in the future.
4. The work described above will require MPI to temporarily vacate the entire building while the seismic strengthening and refurbishment works are taking place. To facilitate this, GPG have negotiated favourable terms in temporary decant space immediately upon vacation of both buildings by the Ministry of Health in favour of their new premises at 133 Molesworth Street. This decant space includes both the neighbouring 3 The Terrace (also owned by the same Landlord) and 25 Aitken Street (Freyberg Building).
5. Operating costs for property generally are forecast to rise significantly over the longer term. The Business Case total project cost (discounted) stood at \$81.000 million over the 20 year period. The final negotiated solution for Pastoral House sees this cost increase by \$7.370 million to \$88.370 million, representing a 9% increase. The increase is predominantly driven by the cost to decant. At the time of the Business Case the preliminary scope of both the landlords and tenants works was such that decanting was not required. However the scope of the work increased due to the extent of the work required to improve the state of Pastoral House.
6. All-of-Government benefits totalling \$8.670 million have not been included in the cost benefit analysis (CBA), refer Table 1. These benefits comprise the waiving of the Ministry of Health's lease tail at 3 The Terrace valued at \$3.890 million by the Landlord, and the receipt of a 'bulk offer' rebate from the same Landlord valued at \$4.780 million.

¹ Note – now hosted at MBIE from 1 April 2016.

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7. The key points from the Development Agreement, Deed of Lease, Deed of Assignment and Deed of Partial Surrender & Variation of Lease are as follows:

- **Landlord:** Precinct Properties Holdings Limited
- **Lease terms** Gross lease with an initial term of 15 years, with three rights of renewal based on 6 years: The target lease commencement date is 14 February 2018
- **Space occupied:** 14,610m² (11.4m² per workpoint)
- **Costs:**
 - **Gross Rent:** The average gross rent for the premise is \$370/m². This equates to \$5.405 million + GST per annum for Year 1
 - **Carparks:** 21 carparks at \$0.110 million + GST per annum for Year 1
 - **Operating costs:** The building operating costs are \$1.040 million + GST per annum for Year 1
- **Incentives:**
 - Landlord to contribute \$0.500 million towards decant costs
 - The effective Gross rent (after all incentives are considered) is \$366/m²
- **Rent Review:**
 - Rent is to increase annually by 1.5%pa with market rent reviews every 6 years
 - Market rent reviews every 6 years with a 10% collar and cap
 - No ratchet clause upon renewals
- **Sublease and Assignment:**
 - Permitted under the lease
 - Ability to sublease or assign single floors due to each floor of the building being recorded on its own Deed of Lease
- **Implementation:**
 - MPI to vacate Pastoral House by 31 January 2017 in favour of 3 The Terrace and 25 Aitken Street (Freyberg Building) upon vacation of these two buildings by the Ministry of Health
 - MPI to take an Assignment of the Lease from Ministry of Health (MoH) to take over their lease for 3 The Terrace which is to be recorded by way of an Assignment of Lease document
 - MPI will enter into a Deed of Partial Surrender & Variation of Lease to vary the lease terms for 3 The Terrace as follows:
 - Surrender 8 surplus carparks & all storage areas
 - Provision for MPI to retain 7 carparks at 3 The Terrace and 5 visitor carparks at Pastoral House during the refurbishment period
 - Reduction of the current rental from an average rental of \$431/m² to \$359/m² pa
 - Extension of the lease term to expire from the Commencement Date of the new Pastoral House lease
 - Removal of all make good or reinstatement provisions from the MoH Lease

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- MPI will enter into a new Deed of Lease for 25 Aitken Street (Freyberg House) upon vacation of this building by the Ministry of Health on the following terms and conditions:
 - Term: 18 months from 1 January 2017
 - Area: 10,360m²
 - Rental: \$320/m² (and \$300/m² for the three lower floors)
 - Rights of Renewal: 3 x one month renewals
 - MPI to take over Ministry of Health's existing floors as-is
 - Landlord to refurbish three lower floors to a leaseable standard (new carpet, painting, removal of surplus fitout)
 - MPI to then assign the lease to the Department of Corrections, from 14 March 2018, who will temporarily occupy the space whilst Mayfair House is being refurbished
 - Landlord to carry out the extensive refurbishment works to Pastoral House including the expansion of Level 4 of the building to include a new building entrance and office space
 - MPI are to complete a new fitout adopting the GPG Workplace Guidelines incorporating new ways of working principles
 - MPI to reoccupy Pastoral House on a new lease commencing circa 14 February 2018
8. Specialist external expertise was used to support the negotiation process in order to achieve the most favourable terms and conditions for the Crown. The Crown's legal services provider used during the negotiation (Buddle Findlay) has certified that all legal documents referred to above reflect the agreements reached between the parties during the negotiations and accordingly, are in order for execution.
9. The key outcomes to MPI and the Crown are as follows:
- Excellent value for money, lower than normal market rates
 - Good building safety and business continuity capability
 - Earthquake-strengthened accommodation
 - Upgraded, expanded and refurbished premises
 - The refurbished premises allows MPI to introduce new working styles and new ways of working
 - The waiving of MoH's lease tail valued at \$3.890 million
 - Securing a bulk offer rebate for Pastoral House valued at \$4.780 million
10. There are commercial imperatives in having the lease signed by the Director-General of MPI by 29 July 2016. The lease was signed by the landlord in early June.

Background

11. MPI participated in a collective head office accommodation business case during 2015 as it has a lease term due to expire in the Wellington Central Business District (WCBD) on 31 March 2017 for the majority of their building, and a lease expiry on 31 January 2018 for one other floor. The Business Case was prepared by the Property Management Centre of Expertise hosted at the Ministry of Social Development (MSD), pursuant to the functional leadership mandate delegated from the State Services Commissioner to the Chief Executive of MSD.
12. The centrally-led procurement and business case process for Wellington head office accommodation resulted in a preferred solution which was approved by Cabinet on 2 June 2015. As part of the preferred solution MPI was identified to reoccupy the building situated at 25 The Terrace (Pastoral House).
13. GPG utilised external specialist property negotiation services (PricewaterhouseCoopers, formerly Wareham + Cameron), legal services (Buddle Findlay) and engineering services (Beca) to support the negotiation of the Development Agreement and the Deed of Lease. MPI supported GPG through this process to ensure that MPI's needs were met and to assist in achieving greater commonality and consistency across government.

Final Commercial Terms

14. As compared to the 2015 business case, the finalised cost-benefit analysis and KPIs of MPI's negotiated solution are as follows:

Table 1: CBA of MPI's negotiated solution

Appraisal period (20 yrs) FY 2013/14 to FY 2032/33	Business Case (June 15) - Preferred Solution	June 16 - Preferred Solution	Difference	
Planning Headcount	1,030	1,276	246	23.9%↑
Planning Density m ² /pp	13.7	11.4	(2.2)	16.3%↓
Area Leased m ²	14,093	14,610	517	3.7%↑
Total Property Cost (\$ million)	167.36	202.54	35.17	21.0%↑
Capital costs (\$ million)	s 9(2)(j)			15.8%↑
Whole of life costs (Real Terms) (\$m)	130.64	141.67	11.03	8.4%↑
Net Present Value (NPV @ 6.5%) (\$m)	81.00	88.37	7.37	9.1%↑
(Shortfall) / Surplus against future funding provisions	(15.15)	(6.86)	8.29	54.7%↓

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Other KPI's - (20 Yr CBA Period)				
Average Total Property Cost \$ per FTE pa	8,124	7,936	(188)	2.3%↓
Average Total Property Cost \$ per m ² / pa	594	693	99	16.7%↑
² Total Capital Cost \$ per m ²	s 9(2)(j)			11.7%↑

The planning headcount for June 2015 included FTE's only. The planning headcount for June 2016 now reflects total workpoints including some growth in FTE's, principally through new Budget initiatives.

15. The key points from the Development Agreement, Deed of Lease, Deed of Assignment and Deed of Partial Surrender & Variation of Lease are as follows:

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The effective Gross rent (after all incentives are considered) is \$366/m².
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 - Rent is to increase annually by 1.5%pa with market rent reviews every 6 years.
 - Market rent reviews every 6 years with a 10% collar and cap
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- **Sublease and Assignment.**
 - Permitted under the lease.
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- **Implementation**
 - MPI to vacate Pastoral House by 31 January 2017 in favour of 3 The Terrace and 25 Aitken Street (Freyberg Building) upon vacation of these two buildings by the Ministry of Health.
 - MPI to take an Assignment of the Lease from Ministry of Health (MoH) to take over their lease for 3 The Terrace which is to be recorded by way of an Assignment of Lease document.

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 - MPI to then assign the lease to the Department of Corrections, from 14th March 2018, who will temporarily occupy the space whilst Mayfair House is being refurbished.
 - Landlord to carry out the extensive refurbishment works to Pastoral House including the expansion of Level 4 of the building to include a new building entrance and office space.
 - MPI are to complete a new fitout adopting the GPG Workplace Guidelines incorporating new ways of working principles.
 - MPI to reoccupy Pastoral House on a new lease commencing circa 14th February 2018.
16. Specialist external expertise was used to support the negotiation process in order to achieve the most favourable terms and conditions for the Crown. The Crown's legal services provider used during the negotiation (Buddle Findlay) has certified that all legal documents referred to above reflect the agreements reached between the parties during the negotiations and accordingly, are in order for execution.
17. There are commercial imperatives in having the lease signed by 29th July 2016.

Financials

18. As directed by Cabinet, GPG has been working with individual agencies and the Treasury to determine the overall funding requirements.

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19. As part of their most recent Four-year Plan (4YP) process, MPI (along with the other WAP2 participants), were requested to identify any funding shortfalls relating to participation in WAP2.
20. On 25 April 2016, as part of the Budget 16 Package, Cabinet agreed to set aside new capital and operating funding in tagged contingencies for WAP2 purposes. Cabinet authorised the relevant Appropriation Minister, the Minister of State Services and the Minister of Finance to jointly drawdown on these tagged contingencies and agree increases to appropriations and departmental capital injections as necessary to provide for WAP2-related costs faced by participating agencies, subject to satisfaction that the requesting agency has adequately demonstrated (e.g. through its Four Year Plan) that it cannot reasonably manage these costs from existing resources².
21. Since the WAP2 business case, some of the assumptions that MPI were considering have changed. This is not uncommon for government agencies where property procurement and implementation occurs over long periods of time.
22. A significant, revised assumption is that MPI is now required to decant Pastoral House during the works period. At the time of the Business Case, the scope of both the landlords and tenants works was such that decanting was not necessary. In terms of the financial impact of this change, an additional s 9(2)(j) has been included in the CBA to cover the cost of items such as physical relocation, IT and infrastructure and the additional operating costs of temporarily operating from two sites (3 The Terrace and the Freyberg building).
23. The final capital cost of the preferred solution is s 9(2)(j) including a s 9(2)(j) contingency. Professional advice received by MPI was to include a s 9(2)(j) contingency at this early stage given the indicative level of pricing received to date. However to be consistent with other agencies at this stage of the programme, MPI has accepted a lower contingency level, but along with other agencies, it may need to access further contingency as costs are confirmed. Incremental capital charge and depreciation is required on this capital injection.
s 9(2)(f)(iv)
s 9(2)(f)(iv)
s 9(2)(j), s 9(2)(f)(iv)
s 9(2)(j)
24. It is anticipated that MPI will incur additional WAP2- related operating costs from early 2017 associated with decanting to Freyberg House and 3 The Terrace. These 'decant' costs are estimated at \$3.220 million in 2016/17 and \$3.360 million in 2017/18. \$500,000 of these costs are being funded by way of a landlord contribution. The remaining costs, along with the higher ongoing depreciation and capital charge costs, were also considered as part of MPI's 2015 Four-year Plan. MPI does not have surplus funding to redirect towards these costs. However, approximately 40% of these costs will be recovered through industry charges which the Ministry cost recovers. MPI has accounted for the ongoing operating costs (other than the increased capital charge and depreciation) in its Four-year Plan and is not seeking an increase in baseline funding for these.
25. Pastoral House is one of five buildings (owned by the Landlord Precinct Properties) that is being utilised as part of the WAP2 preferred solution. GPG has managed to secure a 'bulk offer' deal with the Landlord, whereby the Crown will receive a 5% rebate on the total Gross rent payable when certain commercial considerations are met. This rebate forms part of the 'additional benefits of between \$6 to \$33 million' that were noted in the June 2015 Cabinet Paper. The estimated value of this rebate for Pastoral House stands at \$4.780 million and

² CAB-16-MIN-0189.04

has not been incorporated into CBA as it is anticipated that this rebate will be returned directly to the Centre.

26. As part of the decant negotiations with the Landlord (Precinct Properties) for 3 The Terrace, GPG have managed to get the Ministry of Health's (MoH) lease tail liability waived. The value of this lease tail stands at \$3.890 million. As this is a direct cash benefit to MoH, this benefit has not been included in MPI's CBA. *"Investors are cognisant that public sector tenants provide stability in cash flow and the potential for rising capital values. The completion of the WAP1 process and outcome of WAP2 will add to investor confidence. Standardisation of office space and lease agreements enacted through the Wellington accommodation projects across the wider market limits variance and increases transactional transparency"*³.
27. Operating costs for property generally are forecast to rise over the longer term; this is due to standard inflationary cost pressures together with lease mechanisms that provide the landlord with a market rate of return. The Business Case total project cost (discounted) stood at \$81.000 million over the 20 year period. The final negotiated solution for Pastoral House sees this cost increase by \$7.370 million to \$88.370 million, representing a 9% increase. The cost increase is predominantly driven by the requirement to decant. A comparative analysis of the total property cost and funding, between the preferred solutions is illustrated in diagram 1 below.
28. The total cost of MPI's alternative option (status quo) is \$208.100 million (nominal terms) which, when considered against current baseline provisions, creates an operating funding requirement of \$47.610 million and a Crown capital funding requirement of \$9(2)(i) over the period.
29. There are risks associated with elements of the Development Agreement that could potentially expose MPI to increased costs, namely detailed specification of the landlord's works. These works will not be specified for some months and MPI would like to propose that \$9(2)(i) is kept available in the tagged contingency established in Budget 2016 to enable the building to be delivered to an acceptable standard (which will be at MPI's costs), should these risks eventuate.

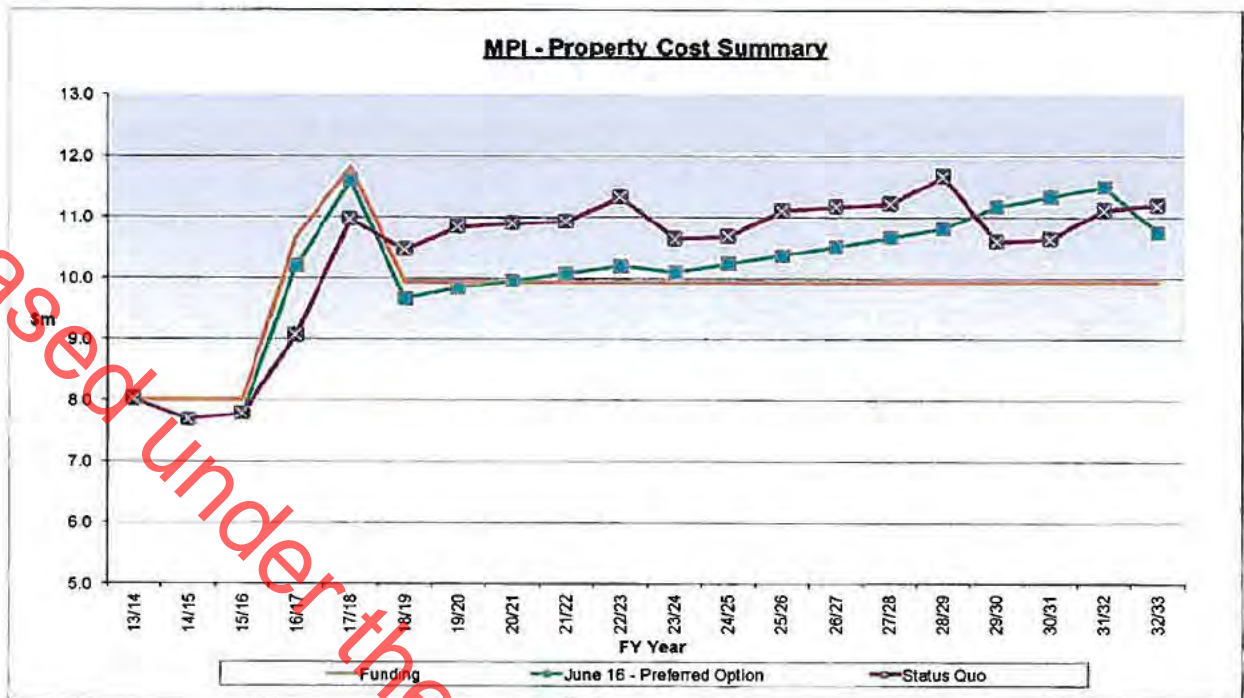
Treasury comment

30. Treasury is comfortable with the process for MPI entering into its new accommodation agreement at Pastoral House and the temporary sites as outlined in this paper. Treasury is also comfortable with the recommendations in this paper, including the proposed increases to baselines in recommendation 7, noting that tagged capital and operating contingencies were set aside at Budget 2016 to provide for additional WAP2-related costs for MPI and other participating agencies that could not reasonably be met from existing Crown-funded baselines. We note that final decant cost estimates for MPI are \$6.58 million higher than originally anticipated, though more than offsetting this are (i) a now-cemented rent rebate for MPI previously not factored into the business case cash flows, and (ii) a reduction in cost pressure for the Ministry of Health from now having its lease tail liability waived. However, while the additional costs need to be met from the tagged contingencies, these tagged contingencies are not 'topped up' to reflect these 'savings'. Therefore, in order to offset these and any other additional WAP2 cost pressures and maximise the amounts available in the tagged contingencies, recommendation 13 proposes that any of the operating and capital funding increases ultimately not required by MPI for WAP2 purposes (e.g. because of lower-than-anticipated decant or fit-out costs, or reduction in applicable capital charge rate) be returned to the WAP2 tagged operating and capital contingencies, respectively.

³ Wellington Office Supply & Demand Report, Colliers, February 2015

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Diagram 1: Total Property Cost & Funding – Current Funding / Status Quo / June 16 Preferred Solution



31. The financial summary for MPI over the 20 year appraisal period, as compared to the status quo, is attached at Appendix 1.

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