6. INTERNAL RENTS

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The purpose of this report is to provide information on the Council's internal rent charging structure and seek a review of the existing policy in this area.

CONTEXT

The Council currently has a policy and practice of charging internal rents. In summary the Council is an owner/occupier of property and this landlord and tenant relationship is separated financially and administratively. In the capacity of a property owner, rental is charged, through the Property Unit, to the various operational/business entities as "tenants" for the property they are occupying to conduct their business.

The issue of internal rentals has been raised on a number of occasions during the Annual Plan budgeting process. These have always been dealt with informally and orally; a formal response has never been sought. A common understanding of this issue across the Council is, therefore, unlikely; nor is there a recent reference for future Annual Plan meetings or similar deliberations.

As a result the Chairman of the Property and Major Projects Committee has requested this report covering the following aspects:

- Existing policy and statutory requirements.
- Rationale.
- Valuation methodology.
- Current practice.
- List of existing properties and rents.
- Financial aspects, eg rates impact.

EXECUTIVE SUMMARY

The charging of internal rents or some other replacement mechanism is necessary to comply with statutory and accounting practice standards. The additional benefits are to reflect the true operational costs where they most appropriately exist; transparency; facilitation of informed decision making and to enable recognition of waste or inefficiencies in relation to property ownership.

As a general principle, internal rents are an allocated overhead and do not impact on rates. Therefore alterations to the current structure or even reducing specific rents will not create scope for increased operational expenditure by the unit "renting" the premises. The only exception to this is where user charges are set based on cost, as internal rents are normally higher than the Council's net costs as very little of the cost of the properties is financed by debt, the charging of internal rents will normally result in higher user charges.

The current process and policy is robust, based on good principles and is implemented on sound and fair fundamentals.

The application of internal rents works in the sense that it applies a commercial discipline and focus to the operational components of the Council's business. Although it possibly creates an adversarial environment which focuses attention on the rents, this is not the design or desire of the practice. Attention should be focused on the how the business is delivered along with the other costs and revenue components.

It is recognised that most of the Council's operational/business activities are undertaken to deliver other intangible benefits eg social, environmental, revitalisation, etc. Without the discipline of charging internal rents (allocating the costs of the infrastructure to provide that activity) the cost of these intangible benefits cannot be properly quantified. It is important that the opportunity cost of using the capital in some other way is factored into the costs of every activity.

RELEVANT CURRENT POLICY

Council Policy

The current policy of charging internal rents is found in Council's Policy Register under "cost allocation – principles of" the relevant extracts from the Policy are:

Principles outlined in the following report by the Group Manager, Finance were adopted by the Council on 23 April 1990, in respect of the 1990/91 financial year.

"With effect in the financial year commencing 1 July 1990, it is proposed to reflect in the finances of each business unit the costs which are indirect and previously have not been shown as true costs of that business unit or its predecessors. These costs fall into the following categories…………. ……………

5. Rents

All property is regarded as being held by the Property Business Unit which charges a rent to each business unit in respect of the property which it utilises. These rents are based on market rentals. Market rentals will not necessarily fully recover the cost of capital charged to the Property Business Unit and the other outgoings of that business unit.

In presenting budgets for each business unit, direct costs will be grouped together to form one sub-total and after this sub-total the allocated costs such as depreciation, overheads, return on capital and rents will be added to bring the sub-total to a total cost for the business unit. After deducting revenues properly due to the business unit, a net cost of that business unit's operations is established and this is met by a transfer of rates to the business unit or a reverse flow if there is a surplus. It may be necessary to phase in user charges which fully recover all these costs where this is intended.

Where a business unit requires capital expenditure, this is kept separate from the operating costs and is financed by capital provided from the corporate financing function. It is on the basis of the full picture of the Council's whole budget that it can decide what sources it will draw on to meet the corporate financing needs of the whole budget. This includes recourse to loan, utilisation of reserve funds and finally rates. Corporate decisions are needed rather than ad hoc proposals by individual business units or committees.

Except for a limited few business units where it is important to separately identify the total and on-going funding of that business unit, the net cost or the surplus will be transferred on an annual basis to general corporate finances. The exceptions are; elderly persons' housing and other specialised rental housing, dog control and parking.

The diagram labelled "Funds Flow Example" seeks to simply illustrate the flow of funds to and from business units and the corporate finance function. While Property is a business unit in its own right, it has particular characteristics because of the charge of internal rents to the other business units. It can be seen from this diagram that ultimately the funds flow ends up in the corporate finance function which is funded from loans, rates or Reserve Funds. Thus while the extent of overheads and return on capital allocated to each business unit may seem very large, the net effect on the rating requirement for each year will not be affected by these internal charges, except for a depreciation which is written off against the value of the assets in the balance sheet.

The important purpose that this rather complex process achieves is to show fully the net cost of each separate Council function in a transparent way".

Statutory Requirements

There are no direct statutory requirements or legislation that obligate councils to specifically establish an internal rent charging regime. However Section 223D of the Local Government Act does confer an obligation to adopt generally accepted accounting practices, and the New Zealand Institute of Chartered Accountants of New Zealand has amongst their required accounting standards a principle that all costs of an operation must be allocated over significant activities. The Christchurch City Council has chosen to do this through the charging of internal rents. A departure from this practice would necessitate the adoption of a replacement mechanism, eg through allocation of the Property Unit's costs to the units.

Strategic Objectives

In addition to the above requirements the philosophy behind the charging of internal rents is to reflect in each business unit the indirect costs of that business so that the true costs of the business are known, understood and transparent. This type of discipline, whether by way of charging internal rents or some other mechanism, as discussed above, is necessary to establish accountability and informed decision making processes. Without some form of measures of cost, there is a risk of inefficiencies, waste of assets and excess numbers of assets being held.

PROPOSAL

This report creates an opportunity for the Council to consider various options with regard to the current policy and practices. In essence the options are:

1. Reaffirm the status quo.
2. Revise the current policy to reflect current practices, should they differ or require improvement.
3. Rescind the existing policy and develop new and different policies and practices.
4. Abandon any principles of allocating property costs to their associated business uses.

We recommend that option 4 is not a prudent or responsible option and should immediately be dismissed without further consideration.

It is not the intention of this report to establish the detail of alternative options for a complete change in practice and associated policy. Should the conclusion, based upon the issues raised in this report, not support either 1 or 2 above we would suggest a resolution calling for a separate report on alternative options and practices, as the implications of other methods and practices require extensive consideration across other units of the Council to understand the financial implications and to develop appropriate policy.

ISSUES

Methodology

Currently the Council’s internal rents are reviewed three yearly. The next review will be undertaken in 2002 with the effects budgeted for in 2003/2004. The rentals are assessed by an independent registered valuer (currently Simes Limited) on an open market basis, assuming a notional ADLS (Auckland District Law Society) net lease format with a nine year term and three yearly rent reviews. These lease terms and conditions are representative of generally adopted market practices.

The rental assessed through the valuation process is what is referred to as a “net” rent; in addition to this a lessee would be expected to pay normal property operating expenses, eg rates, insurance, contracts and maintenance etc. The business units’ budgets in turn include both the net rent and operating expenses of the property. When combined these form what is referred to in the marketplace as a “gross” rent. As a generalisation it is not uncommon, particularly in lower grade and smaller or shared accommodation for landlords and tenants to operate under a “gross” lease arrangement, rather than “net”. The essential difference is that under a gross lease the landlord takes the risks and rewards on increases or decreases in operating expenses between rent reviews. We point out that our reference here to property expenses does not include tenant consumables, eg power and tenancy cleaning, these are always a tenant’s operational cost. Such tenant consumables are however not generally separated in the Council’s approach to its property accounting. Therefore a direct comparison between gross market rents and a derivation of the gross rent from the Council’s property budgets is sometimes not an apples with apples comparison.

The rental assessment represents a current market level that is considered fair and reasonable to both parties, ie landlord and tenant and which does not advocate a position for either, ie a willing lessor and lessee.

Where possible the rentals have been derived from market data such as leases of other comparable property. However, much of the portfolio comprises property types that are not normally found in the private sector marketplace. Where directly comparable market data is not available, the rentals have been assessed reflecting the location and quality of the building relative to other commercial and residential rentals and any limited market data.

For some highly specialised buildings where there is no comparable market evidence the rental has been based on a reasonable return on the depreciated costs of the structure plus the value of the land. This is quite a common method employed for specialised structures as it ensures the owner of the specialised asset achieves an adequate return on its expenditure. Obviously specialised assets would not be created if owners could not generate a reasonable return in doing so. The methodology employed in these instances is logical and financially robust, particularly in consideration of the objectives and rationale.

The primary difference between the methodology employed for the Council's process of determining internal rents and what might happen in the private sector is that the Council's process does not contain an adversarial/ negotiation component. We rely on the valuer to assess a rental that is equitable to both parties in light of what might be fair and reasonable in terms of market evidence and other financial considerations.

As a check to ensure equity and appropriateness there is a process within the Property Unit where some net rents (assessed by the registered valuer, plus actual operating expenses) are benchmarked against an independent market assessment of gross rents. In addition for some properties, in particular the car parking buildings, the rentals have also been benchmarked against a pure financial comparison through the consideration of a cost of capital recovery on the depreciated cost of the asset.

A list of the current properties to which internal rents are applied is attached, including the current rental and method of assessment.

Rates and Financial Impact

Removal of internal rents or some other cost allocation mechanism is not appropriate, not only for the statutory reasons mentioned above but also for reasons of transparency and acknowledging the true costs of the Council's operations. It should also be noted internal rents do not contribute to the rates requirement of the Council.

Removing internal rents understates the true costs of the various business entities. It has the potential to distort investment and operating decisions for both the Council and the private sector. For example, the removal of the internal rent on car parking facilities would make them appear more profitable. Therefore, in financial terms, without consideration to the cost of providing the asset or the demand and supply issues, it would appear quite profitable to continue building more car parks. This however may not be the case. Conversely, if parking charges are kept artificially low because the full costs of operating the car park buildings are not included then the private sector will be discouraged from investing in car parks and the Parking Unit will not have the challenge of matching private sector competition.

It is important to understand that internal rents are an internal paper transaction only and do not represent a real cash flow. Therefore reducing internal rents will not create an opportunity for other expenditure or an increase in other operational costs.

Example – Return on Investment/Profitability

There are some issues in respect of return on investment and profitability that we suspect are not clearly understood and are somewhat complex in their nature. However by way of a simple illustration, utilising the attached Lichfield Street car park budget, the following outlines some of the matters that need to be considered when interpreting the Council's budget and in the development of future policy and practices.

In summary:

Business/Operational Component of Providing the Lichfield Street Car Park Service (I.e. Parking Unit budget)

Operational Costs (including internal property rental $944,000)	$1,439,000
Revenue (External)	($1,197,000)
Net Cost	**$242,000**

Property Component of Providing the Lichfield Street Car Park Service (i.e. Property Unit budget)

Property Costs	$371,000
Revenue (Internal $944,000 & external)	($968,000)
Net Profit	**($597,000)**

As indicated this model depicts the operational component of the Council's car parking service (Parking Unit) as producing a loss. Viewed in isolation it appears as though car parking is a loss venture for the Council. However the Property Unit is making a profit on the provision of the building for that service. In actual fact, in financial terms when combining the sub-budgets the net position for the Council overall is a net profit of $355,000. This could be taken to indicate that the provision of parking is a profitable enterprise for the Council to undertake but this is not correct. There is no proper cost of capital charge on the Property Unit because accounting standards will no longer allow such a notational charge to be made. For this reason the loss on the Parking Activity itself is the nearest figure to the true cost.

In terms of return on investment the Council records the amount of capital invested in this building as $6,243,000. If there was a charge for the capital employed at 6.8% this would amount to $425,000 p.a. This would reduce the profit in the Property Unit to $172,000 and when combined with the loss on the parking activity of $242,000 makes an overall loss of $70,000. The rate of return overall is -1.12%. In fact, the loss on parking of $242,000 is a reasonable reflection of the loss as if the Council had to rent the premises and makes for a reasonable comparison with competitors. This could be viewed as the true opportunity cost of the Council's provision of a car parking service. This may well be able to be justified in terms of the benefit brought to central city revitalisation, promotion of retailing, achievement of traffic strategy etc but at least the figures should be transparent.

The Director of Finance comments:

"The use of internal rents is an important component of reflecting the true opportunity cost of Council activities. Where significant capital resources are utilised then it is important that the accounting reflects the fact that if those assets were not employed they could be put to an alternative use, disposed of or the funds reinvested in an interest bearing deposit. Internal rents is a fair way of reflecting those costs against each activity and makes for an even playing field which is important especially where there are competitors in the same service delivery. Even if there are no competitors it is appropriate to be able to see clearly what has been foregone to achieve each output".

CONSULTATION

This matter does not require consultation with Community Boards or the public. Unfortunately time has only permitted this report to be prepared from a property perspective, with very brief and limited consultation with the Council's Internal Solicitor and Principal Accountant. Given more time, consultation with a broader range of the Council's financial staff would have been appropriate and it could be argued that all business units occupying a Council owned property to which internal rents are being applied are a stakeholder and could possibly therefore warrant some consultation.

CONCLUSION

In summary the key issues are:

- Internal rents or some other form of cost allocation is necessary.
- Internal rents generally have no adverse impact on rates (internal paper transaction).
- The utilisation of internal rents to allocate costs is based on good principles.
- The assessment of internal rents is fundamentally sound.
- Abandoning internal rents would require another mechanism to be developed for the allocation of costs across business activities. Therefore in practice the profitability of the business units would not be substantially different.
- The effect of internal rents provides a number of benefits.
  - Transparency
  - Facilitation of good decision making
  - In part provides for intangible benefits to be costed
  - Focuses attention of business and property managers on other costs, revenue items and delivery method issues.

In conclusion we would recommend retention of the existing policy and practice with the addition of the following sentence at the end of the first paragraph of the existing policy, as a point of clarification:

"Except in the instance where no comparable market evidence is available, in which case a reasonable return, eg the Council's cost of capital is applied to the depreciated cost of the structures, plus the value of the land."

Recommendation:

1. That the current policy and practices are reaffirmed.

2. That the first paragraph of the existing policy be altered to read as follows:

   "All property is regarded as being held by the Property Business Unit which charges a rent to each business unit in respect of the property which it utilises. These rents are based on market rentals. Market rentals will not necessarily fully recover the cost of capital charged to the Property Business Unit and the other outgoings of that business unit. Except in the instance where no comparable market evidence is available, in which case a reasonable return eg the Council's cost of capital is applied to the depreciated cost of the structures, plus the value of the land."

3. That the Property Asset Team consider this issue as part of its future asset plan development, particularly practice standards and suggested supporting policy, and report back to the Council on whether there is a necessity to improve the methodology associated with investment modelling and reporting.

Chairman's Recommendation: For discussion.