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**Australian Federal Government Property Sales 1996-2001
- Issues That Won't Go Away -**

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Abstract: *The current (conservative) Australian Federal Government, first elected in 1996, sold almost \$1bn worth of government-owned real property assets, mainly public servant-occupied office buildings, in the years from 1996 to 2001. Many of these properties were sold on a sale-and leaseback basis, with secure, long term (15 years or more), Federal Government occupancy leases attached. The financial logic of the sales was the subject of considerable debate at the time; a subsequent Australian National Audit Office report was very critical of both the logic and effectiveness of the process.*

The case highlights three critical financial and economic issues that have great import for both government asset sales and public private partnerships, namely:

- *The rules to be applied to the making of decisions to either retain or dispose of government owned and used assets, or to either fund new asset developments from borrowings or enter public private partnerships – i.e. to fund public assets from government borrowing or private borrowing*
- *The calculation of governments' cost of capital relative to that of the private sector and*
- *The impact of the riskiness of the assets themselves and their various revenue streams on the discount rate used in the hold/sell decision*

The research involved: a literature search of the relevant financial and economic theories underpinning these issues; a search of the available documentation on Australian Federal Government asset sales including, where possible, reading of the original sources referenced within that documentation; interviews with some of the participants at various levels in either the government asset sales from 1996 to 2001 or in the subsequent inquiries into those sales. The findings of the research were that there is little or no credible theoretical or empirical support for the assumptions underlying the decisions to sell and lease back the assets in question.

Introduction

The events surrounding the actions of the Australian Government in 1996, in selling and leasing back much of its portfolio of public servant-occupied buildings have been widely canvassed in the political arena. They have been exhaustively examined by the Australian National Audit Office from a probity viewpoint. Clive Warren (2003) provided a useful critique from a corporate real estate portfolio management perspective.

This paper examines some issues of principle that the events described have highlighted, which issues seem to be important for asset decisions made by government at all levels, whether those decisions relate to buying, developing, selling, leasing or entering into partnerships with the private sector. The issues relate to formulation of decision rules, public sector cost of capital and the riskiness or otherwise of the various revenue streams.

Background

The Coalition Australian Federal Government under the Prime Ministership of John Howard was elected in 1996. On occupying the Treasury benches, it immediately accused the former government of having incurred and hidden an \$8 billion budget deficit. The size or even the existence of the “\$8 billion black hole” is debated even to this day, but it did form the rationale for the government breaking some spending promises made before the 1996 election and created a sense of urgency about repaying government debt.

The budget deficit became the initial reason given for a campaign of debt repayment, but what was the real impetus to repay all government debt? The Federal Treasurer and it seems some influential Treasury officers, share the view that debt is only bad if incurred by government, but not a problem if incurred by the private sector. This is a matter of much theoretical controversy among economists, coupled as it often is with the debate about the ideal size of the government sector in the economy. Nevertheless, at a practical level governments in Australia and elsewhere have come to eschew government borrowing in favour of private sector provision and funding of public services and infrastructure. The use of services and infrastructure is fully or partly funded from annual budgets, or paid for directly by consumers of those services and users of infrastructure. The latter-day predilection for low or no government debt is only raised here because it provides a logical motive for the government’s actions overriding the counsels of financial orthodoxy that are discussed in this paper.

The first step the Federal Government took was to set up a Business Review Group (BRG) in June 1996 to assist government “to establish a considered position regarding the role of property ownership and management in securing public sector efficiency”. In July 1996 the government endorsed a set of Commonwealth Property Principles setting the decision framework for hold/sell decisions for Commonwealth property (ANAO 2001).

A Commonwealth Property Committee (CPC) was established to implement the Commonwealth Property Principles and their review commenced with Australian office properties. The divestment strategy resulting from this recommended the sale

over three years of 59 Office Estate properties with a book value of over \$1 billion and was endorsed by the government in April 1997 (ANAO 2001).

The Department of Finance's Property Group coordinated the sales through its Divestment Unit, although the process was run through the use of private sector due diligence, legal consultancies, marketing and sales. The three year divestment program involved total gross proceeds of \$983 million at April 2001, with three of 59 properties remaining unsold. At that stage, revenue targets had been exceeded by 15% (ANAO 2001).

The 2001 report of the Australian National Audit Office was particularly critical of the (high) hurdle rate of return that the office properties had to achieve in order to be retained and of the lack of detailed evaluation of the terms of the sale and leaseback transactions by which most properties were divested. The report made many recommendations for improving future decision making. The Department of Finance specifically rejected the criticisms and recommendations, but the program was apparently suspended after parliamentary airing of the Australian National Audit Office Report.

Methodology

The primary methodology in this study was the literature review. It was necessary to review literature regarding the circumstances of the asset sales in question and the various critiques of the Australian Government's actions at the time.

In order to understand the theoretical underpinnings and current industry practice, the literature relating to hold/sell and similar decisions, cost of government capital, and property asset risk was reviewed.

Both types of literature review were supplemented by informal confidential interviews with authors and with various other people involved in the actual events described. These interviews served to confirm and to round out the information on the public record.

The Discount Rate Issue

The mechanics of the retain/divest decision requires the use of a hurdle rate or discount rate. Finance had chosen a hurdle rate of 15% to make such decisions, but it turns out that this was a crucial choice. One of the most startling pieces of analysis contained in the ANAO report (2001) indicated the considerable sensitivity of the property sell-or-retain decision to the hurdle rate chosen.

Figure 1.

	22% (\$232m)	31% (\$326m)	99% (\$1038m)
Sell	78% (\$820m)	69% (\$726m)	1% (\$14m)
Retain	10 per cent	12 per cent	15 per cent
	Rate of return (Hurdle rate)		
<small>Note 1: Based on property book values as at 30 June 1996 used by the CPC.</small>			
<small>Source: ANAO analysis of Finance records.</small>			

Figure 1 (ANAO 2001) shows that the 15% rate essentially meant that virtually all government property assets should be sold. However, redoing the evaluation using 10% (the rate considered appropriate by Finance's first consultants in 1999, and repeated in July 2000) indicated only eight of the 59 properties, or 22% by value would have been sold.

Finance was proposing a 15% hurdle rate as early as February 1998. In its submission to the Senate Finance and Public Administration References Committee it stated that "Given that the cost of capital to the Commonwealth is around 12% to 14% the hurdle rate of 15% used in the financial analysis of the government's domestic property holdings was arguably too low. The evidence suggests that hurdle rates in the private sector are commonly 15% after tax and that some companies involved in property development use hurdle rates in excess of 25%. At the time the decisions were taken on domestic property, the hurdle rate adopted by Commonwealth GBEs began at around 15% to 20%. The Commonwealth Property Committee therefore erred on the side of caution using a hurdle rate of 15%."

Even earlier, Finance had advised the CPC that Commonwealth property projects had been approved with nominal rates of return of 14% to 15% and that this rate seemed to them to be the appropriate figure for decisions about divestment or retention of existing property holdings. Finance claimed that the government endorsed setting the hurdle rate at this level and advised that it was based on the following logic:

- An assumed risk free rate of return of 6%
- A property risk premium of 6%
- A further 3% to reflect the additional risk incurred by the Commonwealth from the sub-optimal nature of the current Commonwealth property portfolio and the management risks associated with owning property.

Finance later appeared to have some doubts or some confusion about the validity of the above process because in its November 1997 discussion paper, *The Choice of Discount Rate for Evaluating Public Sector Investment Projects*, the authors stated that “other dimensions to risk arising from uncertainty in estimating the costs and benefits or concerns about possible biases that may be introduced by over-zealous proponents of a project should not be dealt with by adding an additional risk premium to the implied required rate of return, but by sensitivity analysis or more sophisticated Monte Carlo methods.” (ANAO 2001, footnote 38, p.40)

In October 1999, for reasons not publicly stated, Finance commissioned a consultant to prepare an analysis of an economically determined hurdle rate of return for property ownership by the Commonwealth. The consultants used the Capital Asset Pricing Model (CAPM) to generate an appropriate hurdle rate of return for public sector investment in property and reported to Finance in October 1999. They argued that a return to commercial property should be above the risk free rate (government bonds) but below the overall rate of return on equity. The consultants considered the measure of property risk or Beta, to be between 0.4 and 0.6 of the expected rate of return on the market portfolio. The report concluded that “the most likely estimate of the return to property is around 10%, although there is considerable uncertainty surrounding this estimate.”

The consultants also stated that they were not aware of the origin and nature of any management risks specific to the Commonwealth that are in addition to the management risk incurred by the private sector and already reflected in the CAPM estimate of the return to property. Hence they were not supportive of the addition of a further risk factor to the CAPM-derived hurdle rate.

In July 2000, Finance commissioned another external consultant to rewrite the CPPs, prepare a paper on the interpretation of the CPPs and determine the Commonwealth’s Social Opportunity Cost of Capital (SOCC). This new external consultant engaged the same consulting firm that prepared the October 1999 report on the hurdle rate of return for property. The report of the consulting firm, submitted in October 2000, assessed the hurdle rate for application to property investment decisions using CAPM and concluded that “the empirical analysis outlined in this report suggests that the Beta of property investment can be estimated at approximately one half. Using a risk free rate of 6.2% and equity risk premium of 5.6%, this suggests a central estimate of the market required return to property of approximately 9%. However there is considerable uncertainty about the appropriate equity risk premium even when estimated over long time periods. This suggests a wide range for the property hurdle return is appropriate, with the upper bound at approximately 11%.”

Finally, another consulting firm was hired and produced a report to Finance in December 2000 which “confirmed” that Finance had been right all along in how they had calculated their 15% hurdle rate. The consultants agreed in their report that it was “appropriate to assess the SOCC on the basis of the weighted return activity of the

total market, plus a conceptual risk allowance factor of 2% to 3% representing the Commonwealth's unique property risk Using the previously assessed risk free rate of 6.2%, plus a risk premium Beta of 1.00 on the total market return of say 6% under current economic conditions, plus the conceptual property risk allowance of 2% to 3%, the current SOCC of 14% to 15% is supportable. On this basis, a SOCC of 14% to 15% appears to remain appropriate.”

At last it seemed that Finance had got the support it wanted for its 15% hurdle rate. However this result has only been possible by a bit of double counting, by resuscitating the claim of a unique Commonwealth property risk factor worth 2% to 3% added to the CAPM calculations, and by doubling the Beta factor for the previous consultant's assessment of a Beta of approximately 0.5. These manipulations make a huge difference to the outcome and in turn a huge difference to the government's lease or own decisions.

Project specific hurdle rates

The question of what is the appropriate discount rate for public sector organisations to use in making lease or own and other decisions such as the value for money question in PPP proposals has led to a vigorous academic debate which is not yet resolved. Grimsey and Lewis (2004) in their book *Public Private Partnerships* devote considerable space (approximately nine pages) to this topic. The views of Kay, Grout, Klein, Argy and others are summarised in the book. In general all those authors support the notion that the cost of capital should be assumed to be the same for both the public and private sectors, and that the apparent advantage of lower public sector borrowing costs ignores the contingent liabilities imposed on taxpayers when governments borrow. They argue that taxpayers are effectively shadow equity providers and that this risk has a cost which should be included in any cost benefit analysis.

Grant and Quiggin (2000), Walker (2000) and others take a contrary view, pointing out that the above argument requires a faith in the efficiency of equity markets which may be unfounded. They point to the work of Mehra and Prescott (1985) who demonstrated in an impressive analysis that the historical average equity premium of 5.6% was much higher than a truly efficient market would deliver (closer to 1%). This issue has subsequently become known as the Equity Premium Puzzle and the implications have not been adequately refuted in the 20 years since its discovery.

So where does this leave us? Grimsey and Lewis (2004) sum up the situation when they say “quite clearly this whole area is one in which there is considerable evolution of thinking at present, and at the time of writing no consensus has emerged on the correct approach, let alone how to put it into practice” (p. 144). However, there is one important issue that all commentators agree on and that is that the appropriate discount/hurdle rate, however difficult it may be to calculate precisely, is project-specific. This means that the risk premium to be added to the risk free rate to get a discount rate should be directly related to the riskiness of the specific project at hand and not some overall average government or corporate cost of capital number. Therefore in the case of the decision of whether to own or lease property assets the risk premium segment of the discount rate determination should reflect the risk of the particular asset and not some overall equity market or property market risk factor.

The government and the Department of Finance failed to take this further step, and so it can be argued that not only are they guilty of overstating the appropriate discount rate for public sector property purposes, but they also failed to adjust the rate downwards considerably for evaluating an obviously low-risk property investment such as a relatively new office building into which a large government department is willing to enter into a 20-year lease and to fit out for its own specialist purposes.

The next part of the paper investigates a case study of such a property that was sold and leased back because it failed to meet the 15% rate of return. It illustrates perfectly the issues that have been discussed so far.

Case Study – The RG Casey Building in Canberra

Sufficient information was able to be obtained from the Auditor-General's report, market reports available in 1998, and conversations with some of the people involved with the transaction, to construct a study of the RG Casey Building. The purpose of the case study is to illustrate the theoretical points made in the previous section. The case study attempts to replicate the analysis that prospective purchasers undertook in 1997/98 with the information that would have been available to them at the time.

The RG Casey Building

The RG Casey building is an office building of 43,218 square metres Net Leaseable Area (specified in lease), located in the inner-Canberra suburb of Barton. More than 16,000 square metres of this is special purpose space, including lecture rooms, laboratories, training and meeting rooms, crisis centres and other special purpose areas that are not found in conventional office space. These special provisions mean that the occupation is quite low-density. The building was completed in September 1996 at a cost of \$161 million, comprising \$104.7 million for basic construction costs, \$21.9 million for consultants and agents fees and tenant's fit-out costs of \$34.3 million. The building can be considered as a conventional office building with specialised fit-out, rather than a specialist building, and can thus be analysed as part of an office market.

At the time, Commonwealth property projects were being approved with a nominal 14% to 15% return. The Australian National Audit Office calculated that, based on rental and rent review procedures consistent with pre-construction commitments, the Internal Rate of Return of the RG Casey Building project was 9.8%.

The RG Casey Building's energy costs are high: an independent assessment in May 2001 commissioned by the tenant department rated the building's energy management systems as being at the lowest level on a five point scale. The independent assessment concluded that, amongst other factors, current lease and service arrangements have restricted the tenant's access to detailed energy consumption costs that could assist it to reduce energy costs. The Federal Government's energy policy at the time forbade leases providing for landlord recovery of energy costs for building central services incurred in normal working hours, but the policy was promulgated almost simultaneously with the sale and leaseback of the RG Casey Building and was not implemented. The upshot is that building energy costs can be passed onto the tenant at rental review, removing any incentive for the building owner to contribute to

energy saving programs. The tenant bears a risk of spiralling energy costs that it can no longer do anything about because the building is now in private ownership.

The Tenancy and the Lease

The building was built for the needs of, and was leased to, the Department of Foreign Affairs and Trade (DFAT). Around 90% of DFAT's staff was accommodated in the RG Casey Building and the building represented some 88% of domestic rental expenditure for the department. The balance of space and expenditure was spread over 14 other leases.

The lease between DFAT and the private owner commenced in April 1998 and expires in February 2012 (13.8 years). The original internal lease term on building completion was 15 years, so the 13.8 years represents the unexpired term of that lease. The commencing gross rental (at April 1998) was \$ 16, 395, 048 per annum (\$379 per square metre per annum gross). This was considered by the Australian National Audit Office to be some 12% over market rental at the time for this particular class of building. This is confirmed by the Property Council of Australia's 1997 and 1998 Investment Performance Indexes.

Additionally, there was an amortisation of agreed capital works, being part of the specialised fit-out, resulting in an annual payment of \$519, 996 from DFAT to the Department of Finance. This payment commenced on completion of the building. When the building was sold, it was decided to include the amortisation cash flow in the sale, a decision about which the tenant, DFAT, was reported to be less than happy.

Rental reviews were 3-yearly to market, making the first rental review in April 2001. Although not relevant to analysis of the sale/leaseback in 1998, it is interesting to note that from April 2001, the building owner was seeking a 38% increase in rental. At approximately the same time, DFAT undertook a re-measurement of the building's net leaseable area to identify possible duplicate charging for space and to resolve the definition of office space. DFAT identified 2,760 square metres for which they were paying office rates of \$379 per square metre per annum as opposed to a supposed storage rate of \$100 per square metre per annum. This illustrates the folly (from the lessor's viewpoint) of including a net leaseable area figure in the lease. Uses of various areas that might attract different rental rates were not defined in the lease, so it would not be possible to get a retrospective adjustment. It is likely that this matter was raised with a view to favourably affecting the rental valuation associated with the impending market rental review. If those figures were correct, the error would account for about one third of the over-rent mentioned above.

DFAT expressed a number of reservations about the commercial aspects of the lease at the time of sale, including the level of rent, rent review provisions, lease terms and arrangements for payment of energy costs. The Department of Finance refused to consider modifying the lease terms on the grounds of detriment to the Commonwealth's divestment program. The inescapable conclusion is that the government was intent on fattening the properties up for sale regardless of the longer term financial consequences for itself as a tenant.

The RG Casey Building is occupied by the one major government tenant for 14 years and the lease terms are typical in that they make the internal fit-out and any re-fits the

responsibility of that tenant. This contrasts with the typical multi-tenanted office building leased to the private sector on short to medium term leases, in which the requirement for capital expenditure by way of redecoration and refurbishment is considerable. Between 1990 and 1998, for example, capital expenditure as a percentage of net Australian CBD office income ranged between 14% and 39% (PCA 1998a). The risk of capital expenditure to meet the tenant's needs thus continues to be borne by the government, which suggests that the need for a sale at a good price overrode risk considerations.

The Sale of RG Casey Building

The RG Casey Building went out to international tender as part of a package with the Commonwealth Centre in Adelaide. Joint sales agents were Jones Lang Wootton and Richard Ellis. The terms of sale provided for purchasers to claim compensation of up to 5% of the purchase price if errors in the information given to tenderers were identified. In the event, no such claim was made.

Market valuation of the building at 30.6.1997 was \$165 million. The final market valuation for sale was \$167 million. The building sold on 24.4.1998 for \$197 million to superannuation funds associated with the Motor Trades Association of Australia in conjunction with Sparad, a wholly owned subsidiary of the Commonwealth Bank.

The successful tender for the RG Casey Building and Adelaide Commonwealth Centre package included a condition that the purchase price could fall by up to \$15 million if interest rates increased. The Department of Finance retained an open exposure to this risk and, as interest rates increased, the Commonwealth received \$4 million less for the package than the nominal tender price of \$221 million. In the analysis for this paper, it was decided to treat the eventual sale price as what the tenderers were willing to pay under the circumstances. The price reduction is interesting, however, as another example of the government's apparent willingness to undertake risk in pursuit of the maximum sale price.

The Australian National Audit Office analysis of the whole-of-lease-term costs for the sale and long-term leaseback found that the RG Casey Building reached a possible financial breakeven point in Year 11 of the lease, after which the Commonwealth could be paying more in rent than it would receive if it invested the property sale proceeds at the Commonwealth Treasury Bond rate,

Analysis of sale and leaseback

In analysing the sale and leaseback of the RG Casey Building, market data were gathered from the period in question (1997/98), as these were obviously the only data available at the time. An attempt was made to replicate the thinking of the investor when considering purchase of the building, not influenced by the hindsight necessarily evident in the Australian National Audit Office's report (ANAO 2001) and of course subsequent events in the property markets between 1998 and 2005.

Assumptions had to be made about prospective growth rates in income and outgoings, of course, although these were based on conditions pertaining in 1997/1998. Because the lease is on a gross rental basis, it was necessary to assume a rate of outgoings per square metre. Given the information that that the building was rated one out of five for energy efficiency, it was decided to go to the higher end of the operating cost

scales examined. It was decided to establish scenarios within a reasonable range of assumptions.

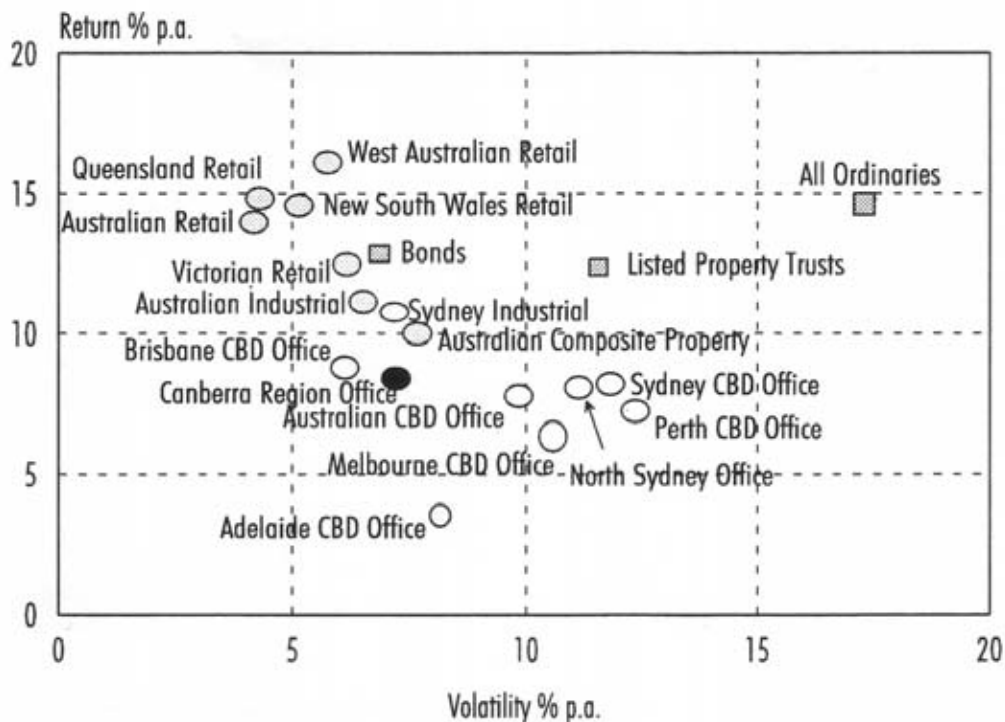
An Initial Yield was calculated on the following assumptions:

- Market rental at commencement \$14,638,435 (based on ANAO finding that rental 12% above market and PCA Investment Performance Indexes 1997/1998a)
- Running costs at \$50 per square metre per annum (PCA Investment Performance Indexes 1997/1998) giving costs of \$2,160,900
- Income from amortisation of capital works \$519,996
- NPV of excess rental yield discounted at 10% for first three years of lease until review = \$5,911,222
- Price paid for market cash flow = \$191,088,778 (\$197,000,000 - \$5,911,222)
- Initial Yield = $\$12,997,531 / \$191,088,778 = 6.8\%$
- Varying running costs to \$40 and \$60 psmpra gave an initial yield range of 7% to 6.5%

The average market return (income plus capital appreciation) on office buildings in the Canberra region for 1997/1998 was 10.2% (PCA 1998a). It seems not unreasonable to conclude that the much lower initial yield in this instance reflects a perception on behalf of the purchasers of lower investment risk than the market average, given that the rental reviews were market-based. The specific risk factors borne by the government as tenant are outlined above, but there is also the general 'blue-chip' nature of a sole-occupier government tenant, with predominantly professional staff, on a 14-year lease.

Figure 2. (PCA 1998a) below best illustrates the risk-return profile of Canberra Region Office, which showed higher return and markedly lower volatility than Australian CBD office from 1984 to 1998. Major Australian CBDs were generally considered less risky than the regions for office investment, so it is probable that the government tenant factor is at work here.

Figure 2.



In 1997, Canberra showed an office vacancy factor of 10.3% (PCA 1998b), which increased through 1998, so the long-term government lease clearly removed the concern that this might have caused any investor.

A further part of the analysis was calculation of an Internal Rate of Return for the investment. The following main assumptions were used:

- Initial outgoings of \$50 per square metre per annum, as outlined above
- Outgoings growth rate of 6% per annum (based on increase in Building Price Index of 8.2% per annum for the previous 10 years, which in 1998 had started to show signs of slowing down)
- Three yearly rental reviews of 25% (allowing 8% per annum that was 1% above predicted inflation from 1998 onwards)
- Residual capitalisation rate of 9.5% (allowing that the building would need quite major refurbishment at the end of its 14-year lease term, but assuming a reasonable likelihood that the tenant might be reluctant to scrap the specialist facilities it provided and would therefore renew the lease. Increasing the residual capitalisation rate to 12% reduces the IRR by only 1%)

The internal rate of return on these assumptions is 13%. This compared favourably with the internal project assumption in 1996 of 9.8% and represented a good return on a very safe investment. Even using pessimistic assumptions, the IRR does not drop below 11% which, it will be recalled, was the upper bound for a property hurdle rate of return suggested by the original consultants employed by the Department of Finance.

Conclusions

The case study used has confirmed the theoretical notion that applying blanket decision rules to specific investment/disinvestment decisions can produce results that can at best be viewed as sub-optimal. As Golan (1999) says, “Although easy to follow and implement, simple rules such as ‘own everything’ or ‘lease everything’ don’t work. Each decision needs to be assessed against a number of criteria which determine the advantages of leasing or owning in a given situation.” Not the least of these criteria are the relative risks associated with leasing or owning a given asset.

In the case of Australian Commonwealth Government asset sales from 1996 to 2001, it is apparent that the government financially disadvantaged its taxpayers, through the establishment of a rule that effectively said “lease everything” and its failure to treat the properties in its portfolio on their merits. It is apparent from their search in 2000 for ex-post justification to satisfy the Auditor-General, that these decisions were originally ideological.

The arguments concerning the cost of capital to the public sector are unresolved in the theoretical sense, with considerable disagreement among economists (Mitchell 2002), but it is generally accepted that the cost of capital should not be used as the discount rate, unless the investment contemplated has the same risk profile as the investing entity (Golan 1999; Ward 1999). The case study demonstrates the disparity between the government’s perceived high general risks of property ownership and some of the actual risks incurred in ownership of a specific property. Indeed, it is arguable that the sale of the case study property has increased the risk to government, or at least decreased its ability to mitigate risk.

The comparison of the respective evaluations of the case study property by the government vendor and the private sector purchaser reveals quite different views of risk. The private sector owner is apparently willing to pay a considerable premium for a strong government tenant on a long-term lease, indicating a perception of low risk. The government, on the other hand, views ownership of the building accommodating the same tenant as too costly to contemplate continuing.

There seems to be little or no theoretical or empirical support for the assumptions underlying the decisions to sell and lease back the assets in question.

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