

# **City of Joondalup**

## **Joondalup Performing Arts and Cultural Facility**

### **Review of JPACF Business Case**

**18 November 2016**

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Garry Hunt  
Chief Executive Officer  
City of Joondalup  
90 Boas Avenue  
Joondalup WA 6027

Dear Garry

**Re: Review of the Joondalup Performing Arts and Cultural Facility Business Case**

Pursuant to our CUA 23706 Audit Services and Financial Advice Order Form dated 15 September 2016, this report sets out our key observations following our review of the Joondalup Performing Arts and Cultural Facility (JPACF) Business Case September 2016 (the Business Case).


We understand that the purpose of the Business Case is to inform the Elected Members on the merits of the JPACF project, prior to embarking on a public consultation process.

Deloitte has been engaged by the City of Joondalup (the City) to review and comment on the Business Case, in particular:

- The financial projections and the basis of the key financial assumptions and supporting information
- The sources of funding (in particular progress with assets sales, National Stronger Regions Fund (NSRF) grant and WATC debt funding) and the proposed financing strategy for JPACF
- Risks, sensitivity analysis and potential variability of cash flows, returns and impact on the City
- The Social and Economic Impact Analysis
- The Cost Benefit Analysis.

If you have any questions or would like clarification about any aspects of the attached report, please do not hesitate to contact me on 08 9365 7287.

Yours sincerely



**Andrew Annand**  
Partner  
Deloitte Touche Tohmatsu

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## **1 Scope of work**

This report sets out the observations that have come to our attention in relation to our review of the Joondalup Performing Arts and Cultural Facility (JPACF) Business Case September 2016 ('the Business Case').

The City of Joondalup (the City) requested that we review and comment on the Business Case, in particular:

- The financial projections and the basis of the key financial assumptions and supporting information
- The sources of funding (in particular progress with assets sales, National Stronger Regions Fund (NSRF) grant and Western Australian Treasury Corporation (WATC) debt funding) and the proposed financing strategy for JPACF
- Risks, sensitivity analysis and potential variability of cash flows, returns and impact on the City
- The Social and Economic Impact Analysis
- The Cost Benefit Analysis.

We understand that the purpose of the Business Case is to inform the Elected Members on the merits of the JPACF project, prior to embarking on a public consultation process.

Our review of the Business Case and supporting documents and appendices provided by Management has included:

- Review of the JPACF Business Case (September 2016 version) and supporting documents and appendices provided by Management
- Discussions with Management including Garry Hunt (CEO), Blignault Olivier (Manager City Projects) and Alan Ellingham (Senior Financial Analyst)
- Discussions with Michael Chappell (Managing Director) from Pracsys in relation to the Market Analysis and Feasibility Study (2012), the Financial Evaluation and Review Final Briefing Note (September 2016) and JPACF Analysis – Economic and Social Impacts (completed 2016).

## **2 Background to the current JPACF Art Box Design**

The City first defined a need for a performing arts facility in 1992 as part of a cultural plan for the City. The City undertook initial feasibility studies during the 1990's and early 2000's. Council approved the purchase of a lot of land for the JPACF development in 2004 and the City finalised the purchase in 2006.

In 2010 the City established a steering committee for the JPACF development. The project philosophy and parameters as adopted by Council in 2011 are summarised below:

- Partnerships
- World Class, state of the art facility
- Imagination and Creativity
- Inclusive Environment
- Viability and Attraction
- Financial Sustainability.

Between 2012 and 2016, the City engaged economic, architectural and engineering consultants to establish the design, financial projections and economic benefits and cost estimates for the JPACF.

In 2012, economic consultants, Pracsys, recommended that the scope and facilities of the JPACF be extended from the traditional performing arts centre to an Art Box Design to better connect with market requirements in the Joondalup area.

The Art Box Design of the JPACF was approved by Council in 2013. The City commenced an international architectural design competition in April 2013, receiving 21 submissions. In April 2014, Council endorsed ARM Architecture as the winner of the architectural design competition for their Art Box concept. A People's Choice vote was also undertaken and was awarded to ARM Architecture.

The current estimated capital cost of the JPACF is currently \$99.7 million. Key approval, development and capital expenditure estimate milestones for the JPACF development have been summarised in Appendix 1.

### **3 The Business Case Development Process**

As noted above, the Business Case has been developed for consideration by Council before a public consultation process is undertaken.

The City has undertaken an extensive process in developing the Business Case for its current purpose. The City has consulted widely and engaged a number of relevant independent consultants to assist with the development. The City also developed a detailed financial model for JPACF (the Financial Model) and we understand from Management that the financial implications have been included in the City's 20 Year Strategic Financial Plan. The process followed by the City to develop the assumptions underlying the financial forecasts appears robust.

In 2012 a comprehensive Market Analysis and Feasibility Study (MAFS) was prepared by Pracsys. The MAFS highlighted that there is currently a significant under provision of performing arts and cultural facilities within the northern corridor of Perth. The MAFS was updated in 2016 and based on Australian Bureau of Statistics data estimated that the demand for performing arts and cultural facilities in the catchment area (incorporating Joondalup, Wanneroo, Gin Gin and part of Stirling) there were approximately 800,000 attendances (this includes all attendances – theatres, studios, conference, general attendance etc.) of which approximately 200,000 were already being consumed (the latter figure was established by a survey). This left a latent or unmet demand of c.600,000 attendances. Management prepared a bottom up estimate of attendance based on the projected utilisation of the Primary and Secondary Theatres as part of the financial modelling process - this came to c100,000 attendances (this did not include general attendances at conferences, studios etc.). Therefore there may be some upside in the assumed attendances at the Primary and Secondary Theatres.

Table 1 below outlines the key financial and economic drivers and the primary sources of input into the development of the Business Case.

**Table 1: JPACF assumption development**

<b>Key financial and economic assumptions</b>	<b>Primary Source</b>	<b>Secondary Source</b>
Need/Demand analysis for the JPACF	Pracsys Consultants (Pracsys) Feasibility Study 2012. Update in September 2016	N/A
Design and Capital Cost	ARM Architecture and quantity surveyors subcontracted by ARM Architecture	N/A
WATC debt funding	Management and preliminary engagement with Western Australia Treasury Corporation (WATC)	N/A
Tamala Park asset sales	Management with reference to Tamala Park Council projections	N/A
Potential NSRF grant funding applications	Management and Pracsys	N/A
<b>Revenue and Costs</b>		
Theatre	Pracsys and reports by the Australian Performing Arts Centres Association (APACA)	Paxon with review by the General Manager of the Mandurah Performing Centre and Ex-General Manager of the Perth Theatre Trust
Conference	Pracsys and public reports by the Australian Performing Arts Centres Association (APACA)	Paxon
Studios	Pracsys and public reports by the APACA	Paxon
Parking	City of Joondalup	N/A
Restaurant leases	City of Joondalup and Paxon Group Pty Ltd (Paxon)	N/A
Sponsorship	City of Joondalup	N/A
Staff costs	Pracsys	Paxon with review by the General Manager of the Mandurah Performing Centre and Ex-General Manager of the Perth Theatre Trust
Building maintenance and utilities	City of Joondalup building and maintenance division	Paxon and Donald Cant Watts Corke
Ticketing income	Ex-General Manager of the Perth Theatre Trust	N/A
Sustaining capital	City of Joondalup and Randall Arts Management Consultancy	Paxon and Donald Cant Watts Corke
Economic and Social benefit analysis	Pracsys	N/A

Although the Business Case broadly includes aspects typically found in a business case, there is limited analysis and commentary on the financial and economic assessment of the alternative options to the Art Box Design. Options analysis is a key component of the Western Australian Government Strategic Asset Management Framework (SAMF). While the City is not required to follow this framework, it does provide useful guidance in the development of Draft Business Cases and ensuring options are assessed objectively. However, Management has advised that the current design has evolved through extensive engagement with stakeholders and Elected Members (which has resulted in additional features/capacity and cost being added to the JPACF concept) and the options assessment is set out separately in the Financial and Option Evaluation prepared in 2015 which has previously been considered by Elected Members.

The Business Case should document in greater detail the rationale as to why the other options are not effective in meeting the project objectives drawing on the analysis contained in the 2015 Financial and Option Evaluation.

#### 4 The development of the financial projections

The JPACF is the largest capital project the City has considered to date and if it proceeds, it will consume significant financial resources of the City, which may be to the exclusion of other future projects. The key drivers of the financial performance and outcomes of the JPACF project are listed below.

**Table 2: JPACF key financial considerations**

Item	Assumption	Commentary
Capital expenditure	<ul style="list-style-type: none"> <li>\$99.7m</li> </ul>	<ul style="list-style-type: none"> <li>Based on value engineered estimates provided by ARM Architecture following engagement of quantity surveyors</li> <li>There is a risk that capital costs are higher than the assumed \$99.7m which will need to be funded and will ultimately have an impact on the total cost to rate payers. See Section 4.2 for further detail</li> <li>c.\$100m is a significant capital and financial commitment for the City and will have a significant impact on the development and funding of future projects by the City. The implications of allocating scarce capital to one project should be considered.</li> </ul>
Sources of funding (nominal)	<ul style="list-style-type: none"> <li>\$37.5m (includes Tamala Park and other land sale proceeds)</li> <li>NSRF grants - \$10m</li> <li>WATC - \$57.8m</li> </ul>	<ul style="list-style-type: none"> <li>The current Financial Model assumes that the City ratepayers will be funding c.90% of the capital costs (ie excluding the NSRF grant) and all ongoing annual operating deficits of the JPACF even though the benefit will be obtained by rate payers in other catchment areas. The City should therefore consider obtaining State or Federal funding to contribute towards the cost of the project</li> <li>Tamala Park and other land / asset sales are also forecast to provide an additional c.\$46m during the JPACF operating stage, which will be used to repay some of the debt. The City has already revised downwards its estimate of Tamala Park sale proceeds and in the current economic climate, there is a risk that further downward revisions are possible. There is a risk that the timing and quantum of Tamala Park and other land sale proceeds are lower than forecast, particularly given the current economic environment and, as a 16.5% shareholder in the Tamala Park Council, the City does not have control over the land sale programme. The impact of delays on the funding profile and funding requirements needs to be considered</li> <li>The \$10m NSRF grant application was unsuccessful. Management has advised that it will seek to replace this shortfall with either WATC borrowing or funding from other sources (including State and Federal grants)</li> </ul>

Item	Assumption	Commentary
		<ul style="list-style-type: none"> <li data-bbox="826 304 1508 427">• Current discussions between WATC and the City indicate that WATC loans of c.\$57m are achievable with a 4% to 5% annual increase in rates. The rate increase last year was approximately 2.5%</li> <li data-bbox="826 450 1508 1205">• There is a financial risk to the City of servicing the proposed WATC loans if the Elected Members do not approve rate increases of 4% to 5% in the next few years in accordance with the 20 Year Strategic Financial Plan (SFP). The City completed a “Shadow Credit Risk Assessment” with WATC earlier this year, based on the Draft 20 year SFP. Management advised that WATC evaluated the proposed borrowings for the JPACF using the same criteria that they normally would as part of any loan arrangement. This involved an overall assessment of the City based on overall income, existing debt, expenditure, etc. Based on this preliminary assessment, WATC advised the City it would qualify for the borrowings. Management advised that WATC also performed a sensitivity analysis assuming that the increase in general rates would result in \$1m less income in 2017/18 (1%) and a further \$1m reduction in 2018/19. On the basis of this analysis, WATC confirmed that the City would still qualify for the proposed borrowings. The City has an annual process to review the proposed borrowings with WATC; this is carried out as part of the annual update of the 20 Year SFP. The next review with WATC will be carried out in early 2017 as part of the 2017 SFP</li> <li data-bbox="826 1227 1508 1350">• There is a risk that debt repayments and interest expenses are higher than forecast, which will impact the total cost of the JPACF on Joondalup ratepayers. The total cost to ratepayers is discussed in Section 4.2</li> <li data-bbox="826 1373 1508 1848">• In September 2016 Management prepared an alternative financing strategy to the City’s traditional fixed rate/fixed repayment term financing (as set out in the Financing Review September 2016). Management has recommended a move towards a financing strategy where there is a more structured approach in matching the term and repayment profiles of the debt facilities to the underlying forecast cashflows of the City, thereby reducing total interest costs. Although this is a move away from the City’s traditional fixed repayment profile, it is a strategy which if managed effectively can reduce the total borrowing costs. However there is always a trade-off between risk, certainty and cost, and Management will need to provide a risk management framework to manage the underlying risk.</li> </ul>



Item	Assumption	Commentary
Operating deficit of the JPACF (excluding financing and capital maintenance costs)	<ul style="list-style-type: none"> <li>Average annual operating deficit of \$863,000</li> <li>Funding and sustaining capex is not included</li> </ul>	<ul style="list-style-type: none"> <li>The projected operating deficit of the JPACF is being subsidised fully by the City ratepayers although there will be a benefit to other non-Joondalup ratepayers</li> <li>The operating deficit excludes the impact of significant debt repayments and sustaining capital expenditure (impact on cashflow) and interest costs and depreciation (the impact income statement). The total cost impact should be made clear in the Business Case (see Section 4.2 below)</li> <li>Based on our analysis to date, there is potential for further downside to the operating performance of the JPACF (refer to Section 4.1)</li> <li>Management has assumed a four year ramp up of JPACF until it gets to a steady state financial performance in year five.</li> </ul>
Sustaining capital expenditure	<ul style="list-style-type: none"> <li>Assumes \$79.4m over the life of the project based on Management assumptions</li> </ul>	<ul style="list-style-type: none"> <li>Management has consulted with the City's asset management team to develop the sustaining capital expenditure profile</li> <li>Management assumptions are significantly different to the sustaining capital expenditure assumptions determined by Paxon (c\$200m) and Donald Cant Watts Corke</li> <li>Management has advised that the estimated life assumptions by Paxon and Donald Cant Watts Corke are not fully based on actual data but based on project estimates from other projects and experience. A separate arts management consultant, Randall Arts Management Consultancy, was engaged and has indicated that the higher estimates are on the high side and inconsistent with actual experience of Performing Arts Centres in Australia</li> <li>Management has advised that it will undertake further reviews in this area by seeking actual data from other facilities in Australia.</li> </ul>

Source: \_Excel file - Project Fin Eval Model (JPACF Sept2016)\_\_v6\_\_(29.09.16).xls

Management prepared an initial risk register and action plan as set out in the JAPCF Project Plan. There is a significant risk that the funding and operation of the JPACF may place significant financial strain on the City, in particular if potential risks such as capital cost increases, operating deficits, debt levels and sources of funding are not properly managed. The City should ensure that the risk management plan is regularly updated to identify, quantify and mitigate key risks.

#### 4.1 Financial analysis

Management has set out the financial projections for the operating deficit of JPACF in the Business Case. Certain assumptions are subject to significant variability and risk, particularly given JPACF will be a greenfield development with no track record of financial performance.

On this basis, further downside scenarios should be considered to address the potential operating and financial risks associated with the JPACF should be developed and included in the Business Case.

Although the Business Case sets out debt repayments, interest costs and sustaining capital expenditure over the life of the JPACF, we suggest that the full cost impact of the facility on a per ratepayer basis is also shown (refer to Section 4.2 for discussion on the total impact on ratepayers).

#### 4.1.1 Operating deficit – downside analysis

Financial projections by their very nature are subject to change. Having regard to the comments by Paxon and Pracsys with respect to potential revenue and costs for the JPACF, we believe a further downside scenario should be considered.

Management has developed worst (Scenario 1), Idealistic (Scenario 2) and Realistic (Scenario 3) scenarios. Table 3 shows the potential operating deficits outlined in the Business Case (Scenarios 1 to 3). For illustrative and discussion purposes only, we have presented an additional potential downside scenario (Scenario 4), which reflects the following additional adjustments to the Business Case's downside scenario (Scenario 1):

- Reduction in secondary theatre operating days to 142 days from 163 days (Deloitte adjustment)
- 5% reduction in primary and secondary theatre ticket prices (Deloitte adjustment)
- 5% reduction in the commercial hire rate for the Primary theatre (Deloitte adjustment)
- A reduction in the number of conferences and functions held to 45 per annum from 90, with a corresponding adjustment to variable costs. Paxon and Pracsys have commented on the existence of other conference / function facilities in the region (which are underutilised), the significant new hotel capacity being built in Perth and the lack of accommodation in Joondalup as being a risk to the utilisation of the conference / function rooms. The 90 conferences / functions were based on the attendance at the Joondalup Resort. Assuming an additional 90 conferences at the JPACF means the market size would need to double, which is unlikely given current economic conditions and the development of new facilities in the CBD
- 10% reduction in studio and exhibition revenues (Deloitte adjustment)
- 10% increase in staff costs (Deloitte adjustment)
- A reduction in the gross food and beverage margin from 33% to 15%. Paxon has noted that food and beverage may operate at a breakeven point
- A reduction in Restaurant turnover to \$3,500 sqm, which has a marginal impact on restaurant lease revenue (based on Paxon report)
- An increase in cleaning and security costs to reflect a recent comparison of other facilities prepared by Donald Cant Watts Corke
- Sponsorship income reduced from \$150,000 to \$100,000. The \$150,000 is a general assumption and Paxon have noted there may be limited opportunities to secure sponsorship. Management has provided additional information in relation to sponsorship it receives for other events and noted that the average sponsorship across all facilities assessed in the APACA report was \$97,000.

**Table 3: Operating deficit (excluding loan repayments and sustaining capex) in year 5 (assumed steady state)**

	JPACF Business Case			Deloitte
	Scenario 1	Scenario 2	Scenario 3	Scenario 4
	Worse Case	Idealistic	Realistic	Potential further downside adjustments
<b>(\$'000, 2016)</b>				
Primary Theatre	\$311	\$391	\$351	\$297
Secondary Theatre	\$125	\$129	\$127	\$109
Conferences, Exhibitions and Studios	\$392	\$392	\$392	\$325
Parking	\$181	\$181	\$181	\$181
Food & Beverage	\$42	\$42	\$42	\$18
Leases: Restaurant	\$63	\$90	\$77	\$63
Sponsorship	\$150	\$150	\$150	\$100
Staffing, Marketing, Admin	(\$1,464)	(\$1,243)	(\$1,342)	(\$1,558)
Building Costs & Utilities	(\$1,078)	(\$791)	(\$969)	(\$1,093)
Ticketing income	\$128	\$128	\$128	\$128
<b>Annual Subsidy (excluding interest and depreciation)</b>	<b>(\$1,150)</b>	<b>(\$529)</b>	<b>(\$863)</b>	<b>(\$1,431)</b>
<b>Subsidy as % of Expenses</b>	<b>27%</b>	<b>14%</b>	<b>21%</b>	<b>33%</b>

Source: \_Excel file - Project Fin Eval Model (JPACF Sept2016)\_v6\_(29.09.16).xls

The City should consider the impact of an increased operating deficit on:

- a. The benefits of the JPACF project
- b. The City's ability to fund operating deficits and potential sources of funds
- c. The City's debt / borrowing capacity and its ability to service Western Australian Treasury Corporation loans.

There is however potential upside through additional utilisation and attendances driving higher revenues, improved profit margins on presented events and lower costs in general. Achieving better financial performance will be driven by engaged and entrepreneurial JPACF management and the ability to activate the assumed latent demand by attracting the right shows which appeal to the demographic. Given available information and the early stage of the project, it is not possible to determine with certainty the potential operating deficit. It is therefore prudent to consider an operating deficit range and conduct stress testing on the City's ability to fund the deficit and the impact on borrowing capacity. Based on current assumptions, the projected annual operating deficit of the JPACF could be between the range of \$500,000 and \$1,400,000 (excluding debt and sustaining capex).

#### 4.2 Impact on ratepayers (total cash cost)

The Business Case highlights the average annual operating deficit of \$899k (or \$13.66 per rate payer in years 6 to 10 – see table 4(b) below) but does not clearly show the average annual cost to ratepayers of including debt repayments, interest costs and sustaining capital expenditure.

Outlined below is the average annual cash cost on ratepayers of the JPACF under the current "Realistic" scenario (Scenario 3 in the Business Case).

**Table 4(a): Average annual cost per ratepayer (Scenario 3)**

Average annual total cash cost to the ratepayer (\$, nominal)	Years 1 - 5	Years 6-10	Years 11-15	Years 16-20	Years 21-25	Years 26-30
Operating subsidy	12.59	13.66	15.68	16.54	20.10	24.42
Sustaining capital expenditure	0.00	0.00	0.00	25.56	18.44	0.00
Debt repayment	52.03	61.00	50.22	0.00	0.00	0.00
Interest	33.35	19.99	5.26	0.00	0.00	0.00
<b>Total cash cost to ratepayers</b>	<b>97.97</b>	<b>94.64</b>	<b>71.16</b>	<b>42.10</b>	<b>38.54</b>	<b>24.42</b>

**Table 4(b): Average annual deficit (Scenario 3)**

Average annual total cash cost (\$, nominal)	Years 1 - 5	Years 6-10	Years 11-15	Years 16-20	Years 21-25	Years 26-30
Operating subsidy	804,443	898,517	1,052,107	1,119,797	1,360,352	1,653,121
Sustaining capital expenditure	-	-	-	1,729,918	1,248,037	-
Debt repayment	3,324,731	4,012,702	3,368,590	-	-	-
Interest	2,130,971	1,314,691	352,682	0	0	0
<b>Total cash cost</b>	<b>6,260,146</b>	<b>6,225,910</b>	<b>4,773,379</b>	<b>2,849,715</b>	<b>2,608,389</b>	<b>1,653,121</b>

Notes: 1) We have excluded Tamala Park land sale proceeds received during the operating period as these funds could be used for alternative purposes / project and use on the JPACF presents an opportunity cost

Source: \_Excel file - Project Fin Eval Model (JPACF Sept2016)\_v6\_(29.09.16).xls

The inclusion of sustaining capital expenditure, debt repayment and interest highlights the significant total cost to ratepayers, increasing the average annual operating deficit to \$6.2m (see table 4(b)) or \$94.64 per rate payer (see Table 4(a)) in years 6 to 10.

As noted above, there is significant risk to the sources of funding and potential for increased costs. Outlined below is a sensitivity analysis on the total cost to ratepayers assuming the following:

- The revised worst case scenario as set out in section 4.1.1 (Scenario 4)
- A 30% increase in sustaining capital expenditure. This increase is, however, still significantly below the nominal life cycle maintenance costs assumed by Paxon and Donald Cant Watt Corke, which have both assumed life cycle maintenance costs of \$200m and \$176m (respectively) compared to Management's assumption of \$79.4m (in conjunction with advice from Randall Arts Management Consultancy). The table below shows sustaining capital expenditure over a 30 year period. It is important to note that sustaining capital expenditure increases significantly in later years (ie >30 years)
- The \$10m NSRF grant is replaced with WATC loans
- Construction costs increase to \$113.2m from \$99.7m, with the increase funded by WATC loans
- There is a 15% reduction in Tamala Park proceeds that contribute to the JPACF reserve fund, the difference being funded by WATC loans.

**Table 5(a): Average annual cost per ratepayer (Scenario 4)**

Average annual total cash cost to the ratepayer (\$, nominal)	Years 1 - 5	Years 6-10	Years 11-15	Years 16-20	Years 21-25	Years 26-30
Operating subsidy	22.34	25.80	29.88	33.31	40.08	48.24
Sustaining capital expenditure	0.00	0.00	0.00	33.23	23.97	0.00
Debt repayment	76.04	89.14	73.34	0.00	0.00	0.00
Interest	48.72	29.19	7.68	0.00	0.00	0.00
<b>Total cash cost to ratepayers</b>	<b>147.10</b>	<b>144.14</b>	<b>110.89</b>	<b>66.54</b>	<b>64.05</b>	<b>48.24</b>

**Table 5(b): Average annual deficit (Scenario 4)**

Average annual total cash cost (\$, nominal)	Years 1 - 5	Years 6-10	Years 11-15	Years 16-20	Years 21-25	Years 26-30
Operating subsidy	1,427,470	1,697,454	2,004,134	2,254,450	2,712,556	3,264,776
Sustaining capital expenditure	-	-	-	2,248,893	1,622,449	-
Debt repayment	4,858,691	5,863,906	4,920,051	-	-	-
Interest	3,113,022	1,920,340	514,895	-	-	-
<b>Total cash cost</b>	<b>9,399,182</b>	<b>9,481,700</b>	<b>7,439,080</b>	<b>4,503,343</b>	<b>4,335,005</b>	<b>3,264,776</b>

Source: \_Excel file - Project Fin Eval Model (JPACF Sept2016)\_v6\_(29.09.16).xls

The inclusion of these additional downside scenario assumptions increases the average annual operating deficit to \$9.5m (see Table 5(b)) or \$144.14 per rate payer (see Table 5(a)) in years 6 to 10.

## 5 Cost benefit analysis (CBA) and Social Return on Investment (SROI) assessment

The CBA completed by Pracsys calculated a benefit cost ratio (BCR) for the project of 2.01, and a social impact ratio of 2.73. These are important considerations in the investment decision to proceed with the JPACF. As noted above, under Scenario 3 (the “Realistic” scenario) there is a financial cost to ratepayers and a net project cost (as opposed to benefit).

Accordingly, the decision to invest in the JPACF is more likely to be based on the economic and social benefits the project provides to ratepayers. Investing in projects that do not provide commercial financial returns but provide economic and social benefits to the community is a key role that local government can and should fulfil.

However, the calculation of economic and social benefits should be based on sound and transparent assumptions and methodologies. To this extent, we have identified a number of key issues that are outlined in full in Appendix 2.

Our key observations are as follows:

- The significant effort undertaken as part of the MAFS work in calculating the potential demand for attendances within the catchment (c.810,000, with c.600,000 estimated to be latent) is currently not sufficiently discussed in the business case. We appreciate that the MAFS document forms an appendix to the business case. However, given the importance of these estimates to the CBA, the City should consider including greater detail in the business case itself regarding the process employed in calculating the demand quantum
- The economic benefits currently expressed in the CBA as transport-related benefits are in fact utility-related benefits, with transport costs used as a proxy for the utility gained by latent consumers who choose to consume arts and culture due to the JPACF. The City should consider renaming the transport benefits as utility benefits. Utility is the majority of the benefit component, and therefore has a significant impact on the BCR
- Given that avoided transport costs are not a conventional proxy for utility, the City should consider detailing the limitations of and rationale for using this approach in the business case
- A number of capture rates drive the value of the utility benefit, however, it is not clear if these capture rates have been modelled, or are pure assumptions. If they are pure assumptions, the City should consider acknowledging this in the business case and presenting in the business case the results of a number of sensitivity tests with higher and lower capture rates to demonstrate how the CBA outcome may change
- The quantum of demand used as the basis to calculate the utility benefit (i.e. c.600,000 attendances) varies from the quantum of demand used to calculate the revenue benefits and the secondary spending benefits (i.e. c.100,000 attendances). A consistent demand scenario should ideally be used to calculate all benefits in a CBA, however, we understand that there may be a viable rationale in the case of the JPAC for utilising different bases of demand. The City should consider making this rationale clear in the business case
- The quantum of demand used as the basis to calculate benefits in the CBA includes attendees from a broad catchment beyond the City of Joondalup. While noting there might be a benefit to persons attending the new facility from councils outside of Joondalup (including regional areas), it will be Joondalup ratepayers bearing the financial cost and risks of the investment. The City should consider undertaking an assessment of the economic and social benefits from a Joondalup ratepayer perspective, or consider strengthening the rationale for Joondalup rate payers to tolerate this risk.

In addition to the observations above and those contained in Appendix 2, we note that Pracsys have already agreed to action a number of other issues during our engagement with them as part of our review of the business case. These include:

- The calculation of the value of travel time savings as part of the utility benefit will be amended such that:
  - A resource value of \$18.90 per hour will be used in place of the \$11.49 per hour previously used. This reflects Austroads (2008) guidance as well as the application of inflation effects to escalate the resource value to 2016 dollar terms. This will have the effect of increasing the BCR
  - The existing estimate of hours saved will be multiplied by a factor of 1.6, which reflects the average vehicle occupancy benchmark from Austroads (2008). This corrects the current calculation, which uses an estimate of 'car hours' rather than 'commuter hours' to estimate this benefit. This will have the effect of increasing the BCR
- The calculation of present value in the SROI model will be adjusted to include the 'Additional Intrinsic Benefits', which is currently excluded from the calculation. This will have the effect of increasing the social impact ratio.

## **6 Summary and next steps**

The City has undertaken an extensive process in developing the Business Case for its current purpose. The City has consulted widely and engaged a number of relevant independent consultants to assist with its development. Significant further work will be required prior to the City making a Final Investment Decision.

In summary we would like to draw your attention to our key observations:

- Financial considerations
  - c.\$100m investment is a significant commitment for a council the size of Joondalup. At this stage the City is assuming that it will fund a 90% of the upfront capital costs (balance being \$10m in grants) and all the ongoing operating deficits and risks, however other non-Joondalup ratepayers will also benefit from the JPACF
  - Given the size of the investment, it is likely that this will have a significant impact on the allocation of capital and the ability to fund future City projects. The City should also consider the impact of the JPACF on its future funding capacity and headroom
  - Although it appears that the City can fully fund the project by a combination of existing cash reserves, WATC debt and land sales there is significant funding risk as a result of:
    - WATC – the repayment of the \$67m loan (including an additional \$10m due to the unsuccessful NSRF grant application) assumes that rates will increase at 4% to 5% per annum which may not be sustainable. The City is currently debt free, so adding \$67m of debt significantly increases the financial risk
    - Tamala Park proceeds - Tamala Park and other land / asset sales are estimated to provide funding prior to JPACF construction commencing. Proceeds from Tamala Park are also forecast to provide an additional c.\$46m during the JPACF operating stage, which will be used to repay some of the debt. There is significant risk in relation to the timing and quantum of sale proceeds given the City does not control Tamala Park Council
  - Financial impact on ratepayers is significant. Based on financial modelling and current assumptions the total cashflow deficit that will need to be funded by ratepayers is projected to be between approximately \$4.8m and \$10.5m per annum in years 1 to 15 (or \$70 to \$163 per rate payer per annum)
  - The JPACF has the potential to place significant financial risks on the City, particularly given it is a greenfield development with no track record of financial performance. If the JPACF proceeds to the next stage of the decision making process, the preparation of a detailed risk, procurement and funding management plan will be essential to ensure that all key risk are identified, quantified and mitigated
- Economic considerations
  - The CBA completed by Pracsys calculated a benefit cost ratio (BCR) for the project of 2.01, and a social impact ratio of 2.73. These are important considerations in the investment decision to proceed with the JPACF. As noted above, there is a financial cost to ratepayers and a net project cost (as opposed to benefit). Accordingly, the decision to invest in the JPACF is more likely to be based on the economic and social benefits the project provides to ratepayers

- The existing BCR is predicated on the assumption that 600,000 attendances will be activated as a result of JPACF. Although this is a significant assumption, the effort undertaken as part of the MAFS work in building the basis for this assumption to calculate the potential demand for attendances within the catchment (c.810,000, with c.600,000 estimated to be latent) is currently not sufficiently discussed in the business case
- The economic benefits currently expressed in the CBA as transport-related benefits are in fact utility-related benefits. Given that avoided transport costs are not a conventional proxy for utility, the City should consider detailing the limitations of and rationale for using this approach in the business case. Utility is the largest benefit component, and therefore has a significant impact on the BCR
- The quantum of demand used as the basis to calculate the utility benefit (i.e. c.600,000 attendances) varies from the quantum of demand used to calculate the revenue benefits and the secondary spending benefits (i.e. c.100,000 attendances). A consistent demand scenario should ideally be used to calculate all benefits in a CBA, however, we understand that there may be a viable rationale in the case of the JPAC for utilising different bases of demand. The City should consider making this rationale clear in the business case
- The quantum of demand used as the basis to calculate benefits in the CBA includes attendees from a broad catchment beyond the City of Joondalup. While noting there might be a benefit to persons attending the new facility from councils outside of Joondalup (including regional areas), it will be Joondalup ratepayers bearing the financial cost and risks of the investment. The City should consider undertaking an assessment of the economic and social benefits from a Joondalup ratepayer perspective, or consider strengthening the rationale for Joondalup rate payers to tolerate this risk
- The City should investigate alternative sources of funding (e.g. State and Federal government grants) to reduce the financial commitment of the City. This would also reflect the benefits that are attributable to non-Joondalup rate payers in the broader catchment area. It is unusual for councils to fully fund facilities the size of JPACF. The City may also need to consider a scaled down facility to reduce the financial commitment of the City
- We understand Management will be continuing discussions with WATC in relation to the debt capacity of the City and the support for the proposed level of borrowings for the JPACF. The City will need to support increasing rates by 4% to 5% each year
- The City will need to develop a clear link between cost to Joondalup rate payers and the specific benefits that are likely to accrue to Joondalup rate payers (as opposed to the benefits to the broader catchment area or non-Joondalup rate payers)
- The Business Case should be updated accordingly.

## **7 Disclaimer and Limitations**

This paper is prepared solely for the internal use of the City of Joondalup. The advice is not intended to and should not be used or relied upon by anyone else and we accept no duty of care to any other person or entity. The advice has been prepared for the purpose set out in our CUA 23706 Audit Services and Financial Advice Order Form dated 15 September 2016. You should not refer to or use our name or the advice for any other purpose.

In preparing these comments, we have relied on, and presumed accurate, the information provided by the City of Joondalup. Except as otherwise expressly stated, we have not attempted to verify the accuracy or completeness of such information. Given that the Business Case has not yet been made 'final', we note that these comments reflect the Business Case at a point in time and that further changes to the Business Case may be made on the basis of the comments in this letter.

Please note that our analysis is subject to the following limitations and caveats:

- We have focused on the Business Case, including the economic and social assessments of the JPACF
- We have not reviewed the technical or costing aspects of the projects
- We have not reviewed the mathematical integrity and logic of the JPACF financial model or undertaken a review of the Joondalup SDP model
- We have not engaged with WATC nor assessed the City's ability to obtain and service WATC loans, and
- We have focussed on the issues and assumptions most material to the project's financial performance and economics.

**Appendix 1 – Key approval, development and capital estimate milestones**

Design	CAPEX Estimate (\$ million)	Year	Milestones	Progression
None	Not Established	1992	Cultural Plan	Defined a need for a performing arts facility
		1996	<b>Hames Sharley</b> , architectural brief	Supported need for a performing arts facility
		2000	<b>Australian Pacific Projects</b> , report	First feasibility study supported a need for a performing arts facility
		2003	<b>Walne &amp; Alexander</b> , report	First resource study and supported the need for a performing arts facility
		2004	Authorisation to acquire land	Commissioners provide the City with approval
		2005	Land purchase negotiations	The City undertakes negotiations with the Government of Western Australia, Department of Education and Training to purchase Lot 1001 Kendrew Crescent
		2006	Land purchase negotiations complete	The City completes the purchase of land for \$584,000
	\$35 million	2009	20 Year Strategic Financial Plan (“SFP”)	Notional amount of \$35 million allocated to JPACF
		2010	Strategic Financial Management Committee, meeting	Defines objectives and parameters of the JPACF and establishment of steering committee
Traditional Performing Arts Centre	\$50.6 million	2012	20 Year SFP	The City establishes initial cost estimate
Art Box	\$79.5 million	2013	<b>Pracsys</b> , Market Analysis and Feasibility Study	Pracsys recommend an extended design (the “Art box” model) to better connect JPACF with market requirements, primarily to include a performing arts centre and conference facilities.
			Council resolution	Council approves Art Box Design for JPACF
	\$90.7 million	2014	<b>ARM Architecture</b> , concept design	New design for JPACF established
			20 Year SFP	CAPEX estimate increased to include additional facilities for JPACF
	\$97.6 million	2015	<b>Donald, Cant, Watts Corke</b> , Engineers report	CAPEX estimate revised based on architectural concept design
			20 Year SFP	The City highlights JPACF as an integral part of its strategic development
	\$99.7 million	2016	<b>ARM Architecture</b> , schematic design report	Updated architectural design for JPACF
<b>Paxon Group</b> , assumptions report			Review of assumptions used in the JPACF financial model	
<b>Pracsys</b> , economic briefing note <ul style="list-style-type: none"> <li>Economic benefit analysis</li> <li>Social return on investment analysis</li> <li>Cost benefit analysis</li> </ul>			Updated brief from economic consultant	



## Appendix 2 – Additional economics related commentary

### Need for the facility

- A clear value proposition is currently not observable for Joondalup rate payers, who are being requested to pay for a facility for which there is regional need. It is recommended that broader discussion be included to strengthen this value proposition (e.g. reference to potential benefits to Joondalup from hosting such a facility, strategic role fulfilled by Joondalup in the region etc.)

### Location, Options and Proposal

- Chapter 5.2 would benefit from greater analytical detail with regard to the options assessment. In particular, it is recommended that more detail is added regarding:
  - Definition of the three options – including scope of the two vanquished options: the cultural campus and the traditional performing arts centre
  - Options assessment – at present, only a brief discussion is provided for why the other two options were dismissed. Greater detail is needed to add rigour and transparency to the process by which the preferred scope was chosen. For example, why does a cultural campus rely on greater land resources? Can a design for a cultural campus with less land requirements not be drafted? And why does the design of the Traditional Performing Arts Centre have major shortcomings when considered against the project objectives?
  - The decision-making process that led to the Art Box Model being favoured.
- Chapter 5.6 states that “*The program model is the most important aspect of operating the facility, and requires dedicated expertise from the management team to drive the program model*”. However, little detail is provided as to the size of or experience sought for the future JPACF management team. It is recommended that further detail is included here regarding the desired size and experience of the team.

### Economic impact assessment

- Consideration should be given to the appropriateness of using Input Output (IO) modelling to assess the impact of a capital investment project. There are several shortcomings to this approach which are documented in publications such as Gretton (2013)<sup>1</sup> and Layman (2000)<sup>2</sup>. A general equilibrium model is generally best when considering economic impacts from capital investment through time. It is recommended that the shortcomings of the IO modelling approach be documented in a footnote to ensure decision-makers are aware of the limitations.

### Demand estimation

- We understand that significant effort was undertaken as part of the MAFS work in calculating the potential demand for attendances within the catchment (c.810,000, with c.600,000 estimated to be latent). However, the extent of this effort and analysis is currently not sufficiently discussed in the business case. We appreciate that the MAFS document forms an appendix to the business case. However, given the importance of these estimates to the CBA (and the likelihood that many decision-makers will not review material contained in the appendices), it is recommended that some detail is added in the business case itself regarding the process employed in calculating the demand quantum. Adding this detail would provide decision-makers with confidence that the estimate of demand is based on a level of rigour. For example, the relevant description and discussion provided by Pracsys on 30/10/16 on these aspects may be sufficient
- We note that the MAFS document does not appear to contain the 810,000 estimate of demand, as this estimate has evolved since the 2012 MAFS report (a quantum of 1,100,000 is referenced in the MAFS). It

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<sup>1</sup> *On input-output tables: uses and abuses*, Productivity Commission, Staff Research Note, September 2013, Paul Gretton. See: <http://www.pc.gov.au/research/supporting/input-output-tables/input-output-tables.pdf>

<sup>2</sup> *The Use and Abuse of Input-Output Multipliers*, Western Australian Economic Summary, WA Treasury, December Quarter 2000, Bruce Layman. See: <http://www.treasury.wa.gov.au/uploadedFiles/ecoresearchchart2002.pdf>.

is recommended that a footnote is provided in the business case explaining the process and rationale by which this estimate has evolved to avoid confusion among decision-makers as to the demand quantum

- The 600,000 estimate of latent demand is a critical assumption, driving outcomes in the CBA. However, this figure is almost 10 times higher than the level of consumption that can be currently verified as occurring outside the catchment (i.e. 66,500), and almost five times greater than the level of consumption currently verified as occurring within the catchment (i.e. the 124,000). In order to give decision-makers a level of comfort that this estimate is appropriate and not overstated relative to current demand, it is recommended that the business case includes some discussion on why this is appropriate. For example, the relevant description and discussion provided by Pracsys on 30/10/16 on these aspects may be sufficient
- There is inconsistency in the CBA with regard to the quantum of demand used as the basis to calculate the utility benefit (i.e. c.600,000 attendances) compared to the quantum of demand used to calculate the revenue benefits and the secondary spending benefits (i.e. c.100,000 attendances). A consistent demand basis is usually adopted to calculate all benefits (i.e. either 100,000 or 600,000) to ensure decision-makers receive a clear picture of outcomes under a consistent demand scenario. However, we understand that there may be a viable rationale in the case of the JPAC for utilising different bases of demand (i.e. service differentiation for paying users versus all users). The City should consider making this rationale clear in the business case.

### **Cost benefit analysis**

- We understand that the economic benefits currently expressed in the business case as transport-related benefits are actually utility-related benefits, with transport costs used as a proxy for the utility gained by latent consumers who choose to consume arts and culture due to the JPACF. We recommend making it clear (i.e. naming it as such) that these benefits are utility benefits, not transport benefits
- In addition, we recognise that avoided transport cost is not a conventional proxy for utility. To ensure that decision-makers fully appreciate the potential shortcomings of this approach, we recommend that the limitations in using this approach are clearly identified in a footnote in the business case, including:
  - Acknowledgement that calculation of this benefit is different to traditional transport economics in that the attendance is latent (i.e. the trip does not occur in the base case)
  - The rationale for choosing to use transport benefits as a proxy, and acknowledgement that a number of other factors are also relevant to the consumption decision (e.g. ticket cost, programming, access to transport etc.) and the rationale for excluding these
  - A brief discussion of how utility would ideally be measured (i.e. the use of preference modelling)
- Given that incremental utility forms the key benefit in the CBA, there is scope for this benefit to be perceived to be overlapping with the benefits claimed in the SROI. As such, we recommend making clear in the business case why these two estimates are distinct (e.g. accrual of consumer surplus versus government surplus)
- A number of capture rates drive the value of the utility benefit. However, it is not clear if these capture rates have been modelled, or are pure assumptions. If they are pure assumptions, it is recommended that this be acknowledged in the business case so that decision-makers can appreciate the risks around the CBA outcome. It is also advisable to sensitivity test these assumptions with higher and lower capture rates to demonstrate to decision-makers how the CBA outcomes change under these scenarios
- There is a possibility that the secondary benefit (being spending outside the JPACF) may be considered a transfer within the catchment. The rationale and assumptions supporting the view that this spending is genuinely incremental needs to be made clear in the business case. The relevant description and discussion provided by Pracsys on 30/10/16 on these aspects may be sufficient
- We understand that the revenue streams included in the CBA are not adjusted for any income re-distribution within the catchment. Rather, it is assumed that any attendances re-distributed from facilities within the catchment are replaced by new attendances, resulting in an overall increase in attendances in the catchment. This assumption needs to be made clear in the business case so that decision-makers are aware

that there is potential for attendances that are re-distributed within the catchment to potentially not be replaced. It is ideal that such a scenario is sensitivity tested

- The quantum of demand used as the basis to calculate benefits in the CBA includes attendees from a broad catchment beyond the City of Joondalup. While noting there might be a benefit to persons attending the new facility from councils outside of Joondalup (including regional areas), it will be Joondalup ratepayers bearing the financial cost and risks of the investment. The City should consider undertaking an assessment of the economic and social benefits from a Joondalup ratepayer perspective, or consider strengthening the rationale for Joondalup rate payers to tolerate this risk.

### **Creative economy**

- We would recommend that Chapter 8 be reviewed for a thorough tightening in logic, explanation and argument. Examples include:
  - Employment Self Sufficiency (ESS) is addressed but not defined, and an explanation of why it's important in the context of JPACF is not provided
  - Data source and timeframe is required for many of the Figures. In particular, if data is from Census 2011, this should be caveated so decision-makers are aware of the age of the data
  - A distinction is made in this chapter between 'strategic jobs' and 'population-based' jobs but a clear explanation of how / why this links to ESS is not provided
  - No academic / empirical underpinning is provided for the 'three-phase system' outlined in the chapter (which is critical to the analysis contained in the chapter). Without any underpinning, this model of growth appears an assertion rather than evidence-based.

### **SROI**

- There appears to be a typographical error in Figure 15. SROI benefits seem to have been charted as intrinsic benefits. These may need to be swapped
- The SROI outcomes shown in this chapter also differ slightly from the SROI Excel model. The business case may need to be updated accordingly.