

## STATUS OF THE FEDERATION SQUARE DEVELOPMENT

**2.221** Federation Square is a major development project encompassing a range of recreational, cultural, commercial, multimedia and entertainment facilities. The Square is situated in the Melbourne central business district at the intersection of Flinders Street and Swanston Street.

**2.222** Responsibility for oversight of the construction and day to day management of the Square rests with Federation Square Management Pty Ltd, a State-owned company.

**2.223** Progress on the development of the Square has been subject to annual audit reviews since June 2000. My most recent report to Parliament on the subject was in June 2002, entitled *Report on Public Sector Agencies*. Key observations made in that report included:

- The estimated completion cost of the Square had increased significantly to \$451.5 million in February 2002. The company's then worst case scenario cost estimate identified further costs amounting to \$16 million which could bring the total estimated cost to \$467 million;
- The then current level of confirmed project funding of \$445.1 million did not completely cover the February 2002 cost completion estimate of \$451.5 million, leaving a funding shortfall of \$6.4 million; and
- The company had executed *Agreements for Lease* for 12 of its 20 tenancies and negotiations were well progressed with a further 7 prospective tenants. Negotiations with a potential tenant for the remaining tenancy had been unsuccessful at that time.

### Summary of issues addressed in this report

**2.224** The main points identified in this further update on the development of the Square are:

- formal opening of the public areas of the Square took place in October 2002 with a significant portion of buildings and works completed at that time;
- an increase of costs by \$21.8 million bringing the latest cost estimate to \$473.3 million for completion of the project;
- confirmed funding for the Square at February 2003 was some \$14 million less than the overall estimated cost;
- the company's cash flow projections indicate that additional funds will be needed from June 2003 to meet remaining project commitments; and
- from a management perspective, the company has made solid progress in attracting tenants to the Square, with 15 out of the 20 available tenancies now operational and an additional 4 expected to be operational during 2003.

**2.225** Following a request by the company for additional funding, the Government approved conversion of a repayable advance of \$14.2 million to a non-repayable grant. Without this action, the shortfall in confirmed funding for the Square would have been significantly higher than the current shortfall of \$14 million.

**2.226** Further, a temporary chief operating officer, nominated by the Treasurer, has been appointed to review the company's financial situation in respect of its project management and operational functions.

**2.227** **This Government action is important as it is critical for the Square's satisfactory completion and its future operations that the rising costs and funding uncertainty associated with the final stages of the project be quickly resolved.**

### **Formal opening of Federation Square**

**2.228** Since my last report, the public areas of Federation Square were formally opened on 26 October 2002. This event signalled the completion of most of the major construction and base building works on the Square. The opening also marked the beginning of a major transition for the company from project construction manager to facility manager of an operational facility.



*Federation Square, Melbourne, viewed from Swanston Street.*

**2.229** At the time of the formal opening of the Square:

- nine of the 20 commercial tenancies had commenced operations (an additional 6 tenancies became operational subsequent to the opening);

- fitout works were proceeding for a number of the commercial tenancies and other major areas of the Square, including the function centre, the Alfred Deakin Building (a multi-storey facility which also houses the Special Broadcasting Service and the Australian Centre for the Moving Image), the amphitheatre, the car park and the Ian Potter Centre (a multi-storey structure displaying the National Gallery of Victoria's Australian art collection); and
- building works were underway for the 2 commercial buildings, known as the Yarra and Transport Buildings, and the area leading from the Square's atrium to the car park.

**2.230** At the date of preparation of this report, the fitout works for the function centre (now known as Zinc Functions), the Ian Potter Centre and the car park were complete and operational, while some fitout works for the Alfred Deakin Building were still underway. The company expects the base building works for the 2 commercial buildings to be completed by the end of April 2003, and major fitout works to be finalised by September 2003.

**2.231** Between October 2002 and February 2003, measured attendances at the Ian Potter Centre had reached 734 300 while the Australian Centre for the Moving Image and the visitor information centre had attracted 496 000 and 264 600 members of the public, respectively.

### **Further increases in the project's estimated costs**

**2.232** Cost increases have continued to be experienced over the final stages of the project, with the company's most recent estimated cost to completion of the Square rising to \$473.3 million, at January 2003. This represents a further escalation in anticipated project costs of \$21.8 million from February 2002 and exceeds the company's then worst case estimate by \$5.8 million. Relevant details are set out in Table 2P.

**TABLE 2P**  
**INCREASES IN PROJECT'S ESTIMATED COST SINCE FEBRUARY 2002**  
( \$million)

<b>February 2002 estimated completion cost</b>		<b>451.5</b>
Building works (mainly for the Ian Potter Centre, the Australian Centre for the Moving Image, the Plaza, the 2 commercial buildings and the Atrium)	15.4	
Managing contractor fees and costs (\$11.7 million for building works and \$200 000 million for fitout works)	11.9	
Fitout works (mainly for the Ian Potter Centre and the Australian Centre for the Moving Image)	2.9	
Contingency (reflects the resolution of project variation claims)	(8.4)	21.8
<b>January 2003 estimated completion cost</b>		<b>473.3</b>

*Note:* The above estimated completion cost includes the costs of fitout of the Ian Potter Centre and the Australian Centre for the Moving Image, some of which is separately funded by the State.

*Source:* Victorian Auditor-General's Office.

**2.233** The company advised that the recent increases in expected project costs are mainly due to delays in the completion of the project.

**2.234** As mentioned in our earlier parliamentary reports, not all of the costs associated with the development of the Square are included in the estimated completion cost. For example, the costs of demolishing the former Gas and Fuel Corporation Towers and Princes Plaza amounting to \$5.4 million, which were met by the State, are not included in the final estimated completion cost figures.

**2.235** At January 2003, \$428.5 million had been expended on the project.

### **Continuing cost risks for the Square**

**2.236** The company's quantity surveyors have progressively identified a number of major risks that could impact adversely on the latest estimated completion cost of the Square. These risks, which represent ongoing project management challenges for the company, involve the potential for higher costs arising from:

- cost variations associated with incomplete documentation;
- trade contract disruption and delay claims;
- managing contractor cost increases (due to further project delays);
- tenancy fitout costs borne by the project;
- consultants' fees and management delivery expenses;
- unplanned prolongation to completion of outstanding works leading to additional costs for the project;
- latent design defects;
- operator initiated changes (post-completion);
- poor or unco-ordinated workmanship; and
- failure to secure full reimbursement for costs of works undertaken on behalf of major tenants.

**2.237** Cost risks do remain in relation to pending and anticipated contract variations and prolongation claims continue to exist, notwithstanding the completion of most of the building and development works on the Square.

**2.238** Prolongation claims of \$9.5 million (submitted by trade contractors, for work disruption and loss of profit resulting from project delays) and unapproved contract variation claims amounting to \$13.9 million remain outstanding. A contingency sum has been provided in the current estimated completion cost to cover any expected payments arising from these claims, however, a shortfall in the contingency amount will be incurred, if the expected settlement outcomes are exceeded.

## Increased funding shortfall

**2.239** As illustrated in Table 2Q total funding confirmed to the company for the Square's development as at February 2003 amounted to \$459.3 million and included contributions from the State Government, City of Melbourne and the Commonwealth Government.

**TABLE 2Q**  
**CONFIRMED FUNDING AT FEBRUARY 2003**  
((\$million))

<i>Source of funding</i>	<i>Total confirmed funding at April 2002</i>	<i>Change since April 2002</i>	<i>Total confirmed funding at February 2003</i>
Grants -			
State Government	304.9	14.2	319.1
City of Melbourne	65.2	n.a.	65.2
Commonwealth Government	50.0	n.a.	50.0
Company borrowings -			
Repayable advance	14.2	(14.2)	n.a.
Loan facility	10.8	14.2	25.0
<b>Total</b>	<b>445.1</b>	<b>14.2</b>	<b>459.3</b>

Source: Victorian Auditor-General's Office.

**2.240** The change in confirmed funding since our last report on the Square relates to a repayable advance of \$14.2 million which the State Government had previously provided to the company for the construction of the 2 commercial buildings; the Transport and Yarra buildings. In February 2003, the Treasurer approved the conversion of this repayable advance to a non-refundable grant in response to the company's December 2002 funding request to the Minister for Major Projects. The Treasurer also indicated to the company that, following this conversion, it could fully access its expanded loan facility of \$25 million.

**2.241** The current level of confirmed funding of \$459.3 million, at February 2003, indicates a funding shortfall of \$14 million against the earlier mentioned estimated completion cost of \$473.3 million.

**2.242** The company's cash flow projections, which assume that the full \$25 million borrowing facility will be drawn-down by April 2003, indicate that there will be insufficient funds to meet estimated project payments from June 2003 unless additional funding is provided by the State or generated from other sources such as private sponsorship.

### **Other funding issues requiring attention**

**2.243** In its December 2002 funding submission, the company advised the Minister for Major Projects that it was able to service only \$18 million of its \$25 million loan facility. In response to the company's concerns, the Treasurer advised that arrangements will be made for additional rental income from 2 government tenants, the National Gallery of Victoria and the Australian Centre for the Moving Image, to address this problem and deal with its immediate short-term financial issues.

**2.244** The company's submission to the Minister also requested additional funding of \$7.8 million to cover a range of other costs which, in its view, required attention.

**2.245** At the time of preparation of this report, the company's funding position was under review by the Department of Treasury and Finance and the Department of Infrastructure. In the interim, a temporary chief operating officer, as nominated by the Treasurer, has been appointed for the company to review its financial position with regard to both its project management and operational functions prior to consideration of any further funding by the State. The Departments of Premier and Cabinet, Treasury and Finance, and Infrastructure are currently identifying details of the specific tasks to be carried out by the chief operating officer.

**2.246** **The current shortfall in funding for finalising the development of the Square, in conjunction with the prevailing project cost risk exposures, could detrimentally impact upon finalisation of the development of the Square and its future operations. We, therefore, recommend that the issue be resolved as a matter of priority.**

### **Delays in contractor payments**

**2.247** Some delays have occurred in the settlement of contractor claims for payment.

**2.248** **Payment of approved contractor claims for the months of November and December 2002, and January 2003 had been delayed by up to 4 weeks due to cash flow management problems.** Ultimately, the company made 3 draw-downs during 2003, (\$2 million in January, \$8.8 million in February and \$7.2 million in March) against its loan facility to enable settlement of approved contractor claims.

### **Status of tenancies**

**2.249** The company has achieved substantial progress since our last report in finalising tenancy arrangements. Tenancy occupation at the Square commenced in September 2002 with the majority of tenants taking up occupancy during October and November, 2002.

**2.250** Some 15 tenancies out of a total of 20 were operational at the time of preparation of this report. The company expects another 3 tenancies to commence operations during May 2003, and one further tenancy to commence during October 2003. Negotiations are continuing to secure another tenant for a significant area within the Yarra Commercial Building. The company advised that leasing documentation had not been finalised for 10 of the operational tenancies at the time of preparation of this report due to delays in fitout works. However, the company, as an interim measure, has entered into agreements for lease in respect of those operational tenancies. The company also has an opportunity to utilise vacant areas within the Eastern Shard, which is currently accommodated by various consultants involved in project management activities.

**2.251** Tenancy activities are critical to the successful operation of the Square, as tenancy rentals constitute a principal source (88 per cent) of revenue for the company. However, as previously reported in April 2002, tenancy rentals in some instances are linked to tenant sales turnover and tenant outgoings are capped, which puts at risk the actual level of tenancy revenue that will be derived by the company. The commencement of tenancy revenue is also dependent upon the timely completion of the tenant's fitout works.

**2.252** Our previous parliamentary reports on the Square have commented on the status of the title to the site, which had resided with the Victorian Rail Track Corporation. This matter was resolved on 19 July 2002, when the company was issued with a Crown Grant for the Federation Square site.

### **Programming of events at the Square**

**2.253** A variety of events have been organised at the Square since its formal opening in October 2002, including the Melbourne Festival, Mercedes Australian Fashion, Melbourne Jazz Festival, Screening of the Australian Open, and a range of public performances and private functions.

**2.254** Forward planning of events is undertaken by the company through the procurement of events up to 12 months ahead of their performance and liaising with festival and events' organisers, as well as various artists to promote the use of the Square.

**2.255** To date, free public events have dominated events and net operating deficits are projected from events to 2006-07. The aim of this deliberate strategy is to create a greater sense of interest, awareness and patronage at the Square.

**2.256** Events programming could represent a potential source of additional revenue for the company, through both increased venue hire and associated positive secondary impacts on car parking and tenancy revenues, if a greater number of commercial events are staged at the Square.

## Ongoing management of the Square

**2.257** In addition to project management of the development of the Square, the company is responsible for its day-to-day operations including marketing and communications, event organisation, commercial services encompassing the car park, venue hiring, tenancy administration and maintenance of the Square. A number of major service contracts relating to security, car park management, cleaning, waste removal and recycling have been executed to facilitate operations.

**2.258** The company significantly reduced its business plan financial projections for the years 2002-03 to 2006-07 during March 2003. While marginal positive cash flows from the operations of the Square are now projected for the longer-term, the amended projections indicate a negative cash flow position for 2002-03 of \$1.7 million. The company attributes these changes to delays in the opening of the Square and commencement of commercial activities.

**2.259** The achievement of projected cash flows will be heavily dependent on a number of key variables, including car park usage levels and tenancy sales (where this determines rental income for the company). As previously outlined in this report, the Government has recently taken action to review the company's financial position.

### *RESPONSE provided by Secretary, Department of Infrastructure*

**The total project cost figure of \$473.3m is misleading.** As identified in the State's response to the 2002 report, the estimated completion cost of \$473.3m is misleading as it includes funding for fitout works of \$43.4m for the National Gallery of Victoria's Ian Potter Centre Museum of Australian Art (NGV) and the Australian Centre for the Moving Image (ACMI). The budget for these works is separately allocated through each agency and has been provided progressively since 1998. Therefore, as at January 2003, FSM's estimated completion cost of the Federation Square project was \$429.9m.

In March 2002, the State provided the project with additional capital increasing the total combined funding from the State, Commonwealth and City of Melbourne to a total of \$394m. In addition the State made available to FSM a \$25m loan facility to be repaid from Federation Square's tenancy revenue. FSM also identified that it could obtain \$3.4m in sponsorship funding and \$1.2m from the City of Melbourne, a total of \$4.6m, to contribute to the cost of the project. Therefore, as at March 2002, the total funding available to the project from all sources was \$423.6m.

**The Auditor-General's report has identified a cost increase of \$21.8m which is misleading.** The \$21.8m includes \$17.6m against the project and \$4.3m against fitout costs for ACMI and NGV. Further, when analysing the \$17.6m, \$11.3m was anticipated and funded by the State for a worst case scenario and \$5m was identified by FSM which the State was not prepared to fund at that time, leaving a \$1.3m "actual" increase in the project's estimated completion cost since March 2002.

**RESPONSE** provided by Secretary, Department of Infrastructure - continued

*In early 2002 FSM advised the State that it estimated the cost to complete the project would be \$396.3m plus \$16m in contingency costs – a total of \$412.3m. FSM further estimated that in a “worst case” scenario the project costs might increase by \$16.3m, a total of \$428.6m. As the State was not prepared, at that time, to provide an additional \$5m in contingency funding on top of the initial \$16m, the total project budget for the worst case scenario, as at March 2002, was \$423.6m. To provide for the initial contingency and \$11.3m to meet the worst case scenario, as identified above, a loan facility with a maximum capacity of \$25m was provided. The capacity to convert FSM’s existing \$14.2m repayable advance was also approved at that time as a measure to increase the loan facility to \$25m if the worst case scenario was required.*

***The total shortfall of \$14m identified in the report is misleading as it includes a \$4.3m funding dispute between FSM and 2 of its tenants (ACMI and NGV) regarding fitout costs. The remaining \$9.7m is as a result of FSM failing to obtain \$3.4m in sponsorship funding and a budget gap of \$6.3m beyond the funding made available by the State.***

*In response to FSM’s request for additional funding, the State has appointed a new chief operating officer. His role will include undertaking a full review of FSM’s financial position with regard to both operational and project management functions, prior to any consideration of further funding by the State.*

---