The Crown Estate
This report has been prepared under Section 6 of the National Audit Act, 1983 for presentation to the House of Commons in accordance with Section 9 of the Act.

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National Audit Office
21 June 1988

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Summary and conclusions

1. The Crown Estate portfolio is valued in excess of £1.2 billion. It encompasses property as varied as shops in Regent Street, clubs in St. James', forests in Scotland, farms, the Windsor parks and the Channel seabed. It is part of the hereditary possessions of the Crown but the Sovereign receives no income from the Estate since all net revenues are paid over to the Exchequer. Management is entrusted by statute to the Crown Estate Commissioners who, as independent trustees, have the statutory duty to maintain and enhance the value of the Estate and the return from it but with due regard to the requirements of good management.

2. Following examination of the Crown Estate’s performance by the Committee of Public Accounts (PAC) in 1982, the Commissioners have, with the help of consultants, reviewed their management structure and systems and their investment appraisal procedures. The NAO set out to examine whether:

   (a) the Crown Estate had made satisfactory progress in updating its management structure and systems to accord more closely with those of the private sector;
   (b) investment appraisal procedures were now adequate;
   (c) full advantage had been taken of the opportunity to improve the Estate; and
   (d) the Estate was achieving a satisfactory return.

3. On the first issue the NAO found that:

   (a) Although the Crown Estate cannot act fully as a private sector property company (paragraph 1.5), the Commissioners had made progress towards restructuring their organisation closer to that of a commercial company. However, more needs to be done. The number of civil servants paid from the vote has been reduced from 113 to 40 but the Crown Estate considers that its ability to recruit and retain staff with specialist skills has been hampered by the retention of civil service rules on recruitment and pay. The appointment of a Deputy Chief Executive from the commercial property sector should provide the momentum needed to introduce further changes which the NAO consider should be accompanied by greater delegation of detailed decision making by the Commissioners (paragraphs 2.2–2.4).

   (b) Property management is shared between in-house surveyors and private agents. There has been no formal financial appraisal of the relative merits of the two types of management (paragraph 2.5).

   (c) A comprehensive strategic review undertaken in 1986–87 has produced investment guidelines, allocated priorities and estimated funds available. It has not, however, produced quantified objectives,
making it difficult to measure achievement. If the Commissioners are to reduce their operational involvement the NAO consider such objectives essential to monitor performance (paragraphs 2.9 – 2.12).

(d) A computerised accounting system and a comprehensive budgetary control system have been successfully introduced together with more detailed capital forecasts which allow the Commissioners to monitor cash flow (paragraphs 2.13 – 2.15).

(e) There has been progress in the development of performance analysis although it needs to be given higher priority and the allocation of more staff resources to obtain full benefit of the potential available. Activity in this area needs to be pursued more vigorously if future strategy reviews and investment and disinvestment decisions are to be properly informed. The Crown Estate has commissioned an independent exercise to produce guidelines of a likely achievable rate of return from the London and suburban estate over the next five years (paragraphs 2.16 – 2.19).

**Investment appraisal**

4. On the second issue relating to the use of investment appraisal procedures, the NAO found that:

(a) The recently introduced guidelines are satisfactory but have not been consistently applied. There have been no final retrospective appraisals to monitor the success of major developments and provide the opportunity to draw out lessons learnt for future projects (paragraphs 3.2 – 3.4).

(b) On lease negotiations, discount rates and assumptions on rental growth should be regularly reviewed following market changes (paragraphs 3.8 – 3.10).

**Estate development**

5. On the third issue relating to development of the Estate, the NAO found that:

(a) The Millbank projects were characterised by delays to completion dates, inaccurate estimates, design problems, and high professional fees such that the final financial results are likely to be considerably worse than expected. At this stage the Crown Estate are unable to quantify the overall profit or loss on the Millbank project (paragraphs 3.12 – 3.20).

(b) The Royal Mint scheme, unlike Millbank, has been funded by an institution and is being developed by a property company with the Crown Estate only contributing the land after completing all the preparatory work and obtaining planning consent. Although this results in profits being shared with other parties the risk borne by the Estate is reduced and by the end of the decade the scheme will be generating about £8 million a year in rent for the Crown Estate (paragraphs 3.21 – 3.22).

(c) The Commissioners' policy for continued development of Regent Street with capital drawn from lease renegotiations is consistent with their overall duty to maintain and enhance the Estate (paragraphs 3.23 – 3.24).
(d) The diversification strategy is based upon the sound investment policy of spreading risk. The direction of diversification into low risk areas is consistent with the Commissioners’ status as trustees (paragraphs 3.25–3.27).

(e) Progress towards achieving the diversification strategy may appear to have been slow due to the inbuilt growth on the London estate. To achieve a more balanced portfolio freeholds in central London would need to be sold. The Crown Estate does not consider the current concentration in central London a great enough risk to justify such drastic action (paragraphs 3.28–3.31).

Borrowing powers

(f) The changing nature of the Crown Estate, in particular the more active portfolio management, suggests that consideration should be given to removing the prohibition on borrowing (paragraphs 3.32–3.34).

Estate performance

6. On the final issue covering the performance of the Estate, the NAO found that:

(a) Before the Estate was valued in 1985, it was not possible to analyse the extent to which the Commissioners had discharged their statutory responsibility to maintain its capital value. Between 1985 and 1987 its value has increased from £900 million to £1,200 million (paragraph 4.1).

(b) The only performance target for the Crown Estate is that agreed with the Treasury of at least maintaining in real terms the revenue contribution at the level achieved in 1977–78. At current prices this would be £12 million and compares with an actual contribution in 1986–87 of £30 million. The changes on the Estate in recent years have rendered the target meaningless and consideration should be given to replacing it with a revised target based upon the inbuilt growth in the London and urban estates (paragraph 4.2).

(c) The revenue return from the London and urban estates has shown exceptional growth during the 1980s rising by more than 100 per cent in comparison with 50 per cent growth shown by market indices. This growth is largely a catching-up exercise as properties leased on rents fixed more than sixty years ago are relet at modern rent levels. Similarly high rates of growth can be expected well into the 1990s (paragraphs 4.4–4.6).

(d) Although revenue growth has been exceptional the revenue yield on the commercial London and urban estate remains low compared with other portfolios. The 1986 yield of 4.9 per cent compared with an average 6.5 per cent on the Investment Property Databank (IPD). This low yield is however more than compensated for by high capital growth which in 1986 produced a total return on the Crown commercial estate of 22 per cent compared with the IPD average of 9 per cent (paragraph 4.6).

(e) The agricultural estates have shown a negative total return in each of the two years since valuation due to a one-third drop in capital value. Similar falls have been suffered by other agricultural landowners but the Crown Estate has taken a long term view and decided not to reduce its agricultural holding. To minimise the
impact of falling agricultural return on overall contribution there is a need to continue to exercise strict control over costs on the estate and move to guideline targets, but with due regard to adequate maintenance (paragraphs 4.11-4.15).

**General conclusions**

7. The NAO recognise that, although weaknesses remain, considerable progress has been made in modernising the Crown Estate since the last examination by the PAC. Systems and structures have been subject to radical change and the Estate valuation has provided an invaluable source of information and made meaningful performance analysis possible. The right foundations have been laid and it is important that these are built upon and that information and analysis systems now available are used to ensure that the full potential of the Estate is realised. Whilst there will always remain areas of the Estate which cannot be expected to offer a full commercial return the aim should be to seek the maximum return achievable within the constraints imposed by the nature of the properties held.

8. The NAO consider that the absence of targets remains the major weakness. There is now no barrier to the establishment of meaningful targets following the estate valuation, and the introduction of data collection and analysis systems. The NAO consider that the outcome of individual investments, the achievement of broad strategies and the performance of the various Estate sectors should be measured against predetermined targets set by the Commissioners within a long term overall return agreed with the Treasury. As circumstances change it would be necessary for the targets to be modified but they should be there to draw the Estate forward, to allow the Commissioners to monitor the performance of their staff and agents and provide the Treasury with a means of assessing the adequacy of the return to the Exchequer.
Part 1: Introduction

1.1 The Crown Estate is one of Britain's largest landowners and has a most unusual and varied portfolio valued at over £1.2 billion (Appendix 1). For more than two centuries the Sovereign has agreed at the beginning of each reign to surrender the annual revenue surplus to Parliament as part of the arrangements for the provision of the Civil List. The Estate remains in law part of the hereditary possessions of the Crown and is not government property.

1.2 Under the provisions of the Crown Estate Act 1961 (the Act) the Crown Estate is administered by a Board of Commissioners. The overriding duty imposed on the Commissioners is that they should maintain and enhance the value of the Estate and the return from it but with due regard to the requirements of good management. The Act requires the Commissioners to pay heed to the needs of the Crown as landowner; to the Exchequer as recipient of revenues and to the tenants and others affected by their decisions as managers.

1.3 The Act also requires the Commissioners to keep the Treasury informed about such activities of the Crown Estate as they may require. The Commissioners submit to the Treasury annually a Broad Programme and Estimates which outlines broad strategic objectives, reports progress on major initiatives and provides financial estimates for the next three years. The Treasury agree this programme and thereafter require the Commissioners to inform them only of significant additions or departures from it. Under the Act the Chancellor of the Exchequer and the Secretary of State for Scotland have powers to give directions to the Commissioners to inform them only of significant additions or departures from it. Under the Act the Chancellor of the Exchequer and the Secretary of State for Scotland have powers to give directions to the Commissioners, but these have never been exercised.

1.4 The only target agreed between the Treasury and the Commissioners is that the annual revenue surplus surrendered to the Exchequer should at least equal in real terms that achieved in 1977-78. These arrangements aim to ensure that the Commissioners are allowed to work with the minimum of direction and control whilst at the same time recognising the need for some government oversight of policy and major matters of management.

Constraints on activities

1.5 The Crown Estate cannot act fully in the same way as a property company in the private sector. The Commissioners, whilst seeking to meet their statutory duty as trustees, face restrictions not imposed upon other property holding organisations:

- they are under an obligation to retain both the character and the broad structure of the Estate;
- their actions must be beyond reproach and in keeping with the public image of the Crown;
- they are statutorily barred from borrowing money and cannot retain surplus revenues which must be surrendered annually to the Exchequer;
- they can only invest in property in the United Kingdom or government securities.


1.6 The Crown Estate receipts (both revenue and capital) have doubled between 1961–1982 and 1966–1987, revenue payments have increased by over 60 per cent and capital expenditure has more than tripled (Table 1). The Crown Estate was comprehensively valued for the first time in 1985, and by 1987 was valued at £1200 million (Table 2).

Previous reviews of the Crown Estate

1.7 The Committee of Public Accounts (PAC) previously considered the performance of the Crown Estate in connection with my predecessor's Report on its 1980–81 Accounts. The Committee drew the following main conclusions:

(a) the Commissioners should not feel inhibited by their inherited portfolio from attempting to secure such improvement in the Estate for which scope existed;

(b) the Commissioners could not satisfactorily account for their stewardship without producing a balance sheet showing the value of capital assets;

(c) presentation of a balance sheet would provide a measure of the adequacy of the revenue surplus and of the Commissioners' achievement of their statutory duty;
Table 1
Accounts summary 1981-82 to 1986-87 (£ million)

<table>
<thead>
<tr>
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<th></th>
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<th></th>
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<td>Revenue</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Receipts</td>
<td>28.0</td>
<td>32.8</td>
<td>39.7</td>
<td>43.9</td>
<td>50.7</td>
<td>56.6</td>
</tr>
<tr>
<td>Payments</td>
<td>(11.5)</td>
<td>(13.6)</td>
<td>(13.5)</td>
<td>(16.2)</td>
<td>(18.0)</td>
<td>(19.0)</td>
</tr>
<tr>
<td>Gross Surplus</td>
<td>16.5</td>
<td>19.2</td>
<td>26.2</td>
<td>27.7</td>
<td>32.7</td>
<td>37.6</td>
</tr>
<tr>
<td>*Vote Funds</td>
<td>1.2</td>
<td>1.2</td>
<td>1.6</td>
<td>0.8</td>
<td>0.5</td>
<td>0.6</td>
</tr>
<tr>
<td>Transfers</td>
<td>(3.5)</td>
<td>(4.4)</td>
<td>(6.1)</td>
<td>(6.6)</td>
<td>(7.6)</td>
<td>(8.6)</td>
</tr>
<tr>
<td>Net Surplus</td>
<td>14.2</td>
<td>18.0</td>
<td>21.7</td>
<td>21.9</td>
<td>25.6</td>
<td>29.6</td>
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<td>Capital</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Receipts</td>
<td>21.7</td>
<td>34.0</td>
<td>52.3</td>
<td>28.6</td>
<td>42.5</td>
<td>50.6</td>
</tr>
<tr>
<td>Payments</td>
<td>(31.3)</td>
<td>(29.9)</td>
<td>(21.4)</td>
<td>(41.4)</td>
<td>(47.4)</td>
<td>(98.1)</td>
</tr>
<tr>
<td>Gross Surplus/ (Deficit)</td>
<td>(9.6)</td>
<td>4.1</td>
<td>30.9</td>
<td>(12.8)</td>
<td>(4.9)</td>
<td>(47.5)</td>
</tr>
<tr>
<td>Transfers</td>
<td>3.5</td>
<td>4.4</td>
<td>6.1</td>
<td>5.6</td>
<td>7.6</td>
<td>8.6</td>
</tr>
<tr>
<td>Net Surplus/ (Deficit)</td>
<td>(6.1)</td>
<td>8.5</td>
<td>37.0</td>
<td>(6.2)</td>
<td>2.7</td>
<td>(38.9)</td>
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* Moneys voted by Parliament to cover the salaries of the Commissioners and the expenses of their office (Class XX, Vote 6, 1987-88)
(Class XX, Vote 7, 1986-87)

Table 2
Estate valuations at 31 March (£ million)

<table>
<thead>
<tr>
<th></th>
<th>1985</th>
<th>1986</th>
<th>1987</th>
</tr>
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<tbody>
<tr>
<td>Central London</td>
<td>524</td>
<td>587</td>
<td>796</td>
</tr>
<tr>
<td>Residential</td>
<td>87</td>
<td>87</td>
<td>110</td>
</tr>
<tr>
<td>Provincial</td>
<td>48</td>
<td>75</td>
<td>103</td>
</tr>
<tr>
<td>Agriculture</td>
<td>200</td>
<td>170</td>
<td>138</td>
</tr>
<tr>
<td>Forestry</td>
<td>9</td>
<td>10</td>
<td>11</td>
</tr>
<tr>
<td>Minerals</td>
<td>17</td>
<td>17</td>
<td>20</td>
</tr>
<tr>
<td>Foreshore</td>
<td>14</td>
<td>16</td>
<td>22</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>899</strong></td>
<td><strong>962</strong></td>
<td><strong>1,200</strong></td>
</tr>
</tbody>
</table>

(d) the accounts should record the reasons for undertaking major developments on a non-commercial basis and the impact of doing so;
(e) the Commissioners' investment appraisal procedures fell short of the standards which should have been applied but new guidelines drawn up with the Treasury after the C&AG's Report and before the evidence session were welcomed.

1.8 A further result of the PAC Report was the commissioning of two independent reports on the Crown Estate. The first (the Rodmell Report) considered the use of quantitative methods for planning and measuring performance and for appraising investments and the second (the Osmond Report) considered the higher organisation and staffing of the Office.

The Rodmell Report

1.9 The Rodmell Report made 56 individual recommendations the thrust of them being that there should be:
- more explicit quantification of the overall estate objectives and of all assumptions made in investment appraisals;
- improvements in planning procedures;
- a more systematic examination of performance.

1.10 To implement the detailed recommendations the Report made it clear that there was a need for improved information. The Crown Estate lacked the information base which would be expected of a major investor and in particular the value of the Estate was not known and there were no in-house computing facilities. The Commissioners accepted the underlying theme of the Report that the increased use of quantitative methods would assist them in their decision making but were wary of introducing the level of detail proposed.

The Osmond Report

1.11 The Osmond Report examined the higher management structure of the Crown Estate and
considered the extent to which it matched the needs of a large property investment organisation. The recommendations were aimed at transforming the Crown Estate from a small traditional civil service department to something more like a first rate property company. The Commissioners accepted most of the recommendations but some of them have been further examined by Sir Leo Pliatzky (paragraph 2.3).

1.12 Against this background the NAO examination concentrated on whether:

(a) satisfactory progress had been made in updating the management structure and systems (part 2);
(b) investment appraisal procedures were now adequate (part 3);
(c) full advantage had been taken of the opportunities to improve the Estate (part 3);
(d) the Estate was achieving a satisfactory return (part 4).
Part 2: Management Structure and Systems

2.1 All the independent Reports on the Crown Estate (paragraphs 1.7 to 1.11) identified weaknesses in management structure and systems and recommended remedial action. The NAO examined whether the Commissioners had responded by updating and improving their management structure and their systems for strategic planning, financial planning and performance analysis.

Management structure

2.2 The underlying message of the Osmond Report was the need for the Crown Estate to be transformed into an organisation more closely resembling a major property company. This was to be achieved largely through a proper valuation of the Estate which would enable agreement to be reached with Treasury on a required rate of return from the Estate; a reduction in the numbers of staff classed as civil servants; the removal of governmental controls over staff numbers and grading and their replacement by commercial disciplines; and an increase in specialist expertise. In response to the staffing recommendations the Commissioners reduced the number of staff paid from voted money and classed as civil servants from 113 to 40; regraded a number of posts to reflect changes in responsibility; and established a new post below the Second Commissioner to rectify the "thinness" in the senior ranks. The recruitment of surveyors from the private sector proved more difficult as recruitment and pay policies were still set with regard to civil service rules. The Commissioners concluded that the changes they had made still did not achieve the objectives identified in the Osmond Report and in 1986 they invited Sir Leo Pliatzky to undertake a further review.

2.3 This review examined the management of the Crown Estate in the context of changes in the London property scene, drawing on the views of the Commissioners, their agents, senior staff and property developers who had had dealings with the Estate. The conclusions reached by Sir Leo Pliatzky were very similar to those of Osmond in recommending that more staff should be recruited from the private sector at a senior level in the Crown Estate. In particular, he recommended that a Deputy Chief Executive post should be created and filled by someone with business and management experience in the property world, and that on retirement of the current Second Commissioner his post should probably also be filled from the world of industry and business, preferably from the property world. The Commissioners have accepted these recommendations and have already appointed the Deputy Chief Executive.

2.4 The Pliatzky Report emphasised the need for the Commissioners to increase the degree to which they delegated authority. The NAO found that over the last ten years capital turnover had increased five fold in real terms (Figure 1) and that in the last six years alone the Commissioners have either made or are committed to making 63 individual investments of over £1 million. In 1986, which was not untypical, the main board and its urban sub-group considered 170 individual papers covering a wide range of issues from matters of policy and sensitive issues down to detailed questions on specific properties. This represents a particularly heavy workload in the context of the part-time nature of the Commissioners' duties, which in the case of the Urban Commissioners is 40 days a year. The Commissioners have decided not to take action to delegate work further until they can assess the effect of the recruitment of the Deputy Chief Executive.

2.5 In addition to their recommendations on senior management, both the Osmond and the Pliatzky Reports discussed the sharing of property management between in-house surveyors and private agents. Currently the management of the London and urban estate is divided between the Crown Estate Surveyor and two private agents. The division of responsibilities is largely historical. Both Reports considered that there would be benefits in reducing the scale of in-house management and allowing the Crown Estate Surveyor to concentrate more upon an advisory role. No changes have been made and there has been no formal financial appraisal of the relative merits of in-house management and management by agents.

Strategic planning

2.6 The main policy objective of the Crown Estate Commissioners is to maintain and enhance the Estate and the return obtained from it. General economic conditions, and in particular property market movements, have in the past meant that this objective could have been met in money terms without active management. The Commissioners have however...
2.7 The Rodmell Report paid particular attention to strategic planning and recommended that:

- operating policy objectives and broad strategies should be more closely integrated and quantified wherever possible;
- the annual planning cycle should be extended to provide a regular review of all strategies, including measurement of performance against objectives, and the validity of these objectives in the light of changing circumstances.

The NAO examined the planning and policy development process within the Crown Estate with the aim of ascertaining what action had been taken on the Rodmell recommendations, and how information had been gathered, analysed and translated into strategies.

2.8 Prior to 1986 there had been no overall review of Estate policy. Strategies and objectives had been determined as the need arose, activated by specific problems facing the Estate, in particular the need to:

- react to the general decline of Regent Street as leases approached reversion. The strategy recommended more active estate management and in particular major redevelopment on a number of properties that were not achieving their potential investment performance.
- spread risk by investing a proportion of the money drawn out of London from lease renegotiations into a new urban "diversification" portfolio.

(a) react to the general decline of Regent Street as leases approached reversion. The strategy recommended more active estate management and in particular major redevelopment on a number of properties that were not achieving their potential investment performance.

(b) spread risk by investing a proportion of the money drawn out of London from lease renegotiations into a new urban "diversification" portfolio.

2.9 In 1986 the Commissioners undertook a complete review of the Estate's investment strategy. The review was undertaken partly in response to Rodmell's recommendations but also to the need recognised by the Commissioners for a more coherent investment strategy. It was made possible by the availability for the first time of the detailed and comprehensive information produced as a result of the Estate valuations.

2.10 The review covered all major estate sectors and produced policy guidelines as follows:

- London: to retain the heartland estate and improve its quality through redevelopment. This to be funded through capital premiums released on lease renegotiations whilst ensuring that 29
per cent of rental value would be collected as annual rent by 2005.

— Urban diversification: to use funds not required for heartland development to establish a balanced portfolio outside London.

— Agriculture: to retain broadly the current size of the portfolio.

— Foreshore and Seabed: to undertake research and adopt a more active management role.

2.11 The NAO examination of the 1986 review found it to be comprehensive, covering all main sectors of the estate other than fair-rent housing and forestry, which had been examined earlier, and Windsor Great Park where there was little scope for investment. The strategies took into account the estate characteristics, history, economic conditions and constraints. Full use was made of available internal management information, comparative data on other portfolios, and expert professional advice. The product was a forward-looking strategy which established investment priorities to assist Crown Estate staff and agents in their decision making.

2.12 The strategy has not, however, quantified the impact of alternative policy options or translated individual strategies into operational plans with specific targets, thus making it difficult to measure achievements. The only target recorded is to receive 25 per cent of rental value as annual rents by the year 2005.

Financial planning

2.13 Until 1985–86 the Crown Estate did not have a comprehensive budgetary control system. Cost estimates for the following year were produced by agents in October and were used to project the annual surplus for surrender but were not incorporated into a formal budget structure. An improved system was introduced in 1985–86 but the Crown Estate could not use it effectively for monitoring and control until the introduction of an in-house computerised accounting system in April 1987.

2.14 Under the current system the aim is to report, in financial terms, the plans of each branch of the office for the coming year and particularly to identify the contribution branches are expected to make to the projected revenue surplus. Once the budgets have been accepted by the Board the surplus becomes the focus for management action, and the purpose of subsequent reports is to ensure that this surplus is achieved. Short-term estimates of the revenue return should be reasonably easy to predict and control, but estimates of capital receipts and expenditure may prove more difficult to assess accurately. Capital budgets are estimated on the basis of approved schemes and known policy objectives but changes in investment opportunity and major movements in capital values can significantly affect such estimates.

2.15 As the annual capital budget is an insufficiently flexible planning tool, monthly capital forecasts are needed to allow the Commissioners to monitor capital cash flow. This is particularly important in the absence of borrowing powers. The 1986–87 monthly capital forecasts included a probability factor for capital receipts to indicate the likely accuracy of the projected balances. This procedure was dropped in May 1987 because the Crown Estate considered that the volume, volatility and individual value of such receipts had increased substantially making the probability factors invalid as an aid to forecasting.

Performance measurement and analysis

2.16 The Rodmell Report recommended that data about the financial performance of the Estate should be systematically collected and compared with other property holding organisations. This could not be implemented without Estate valuations against which to measure capital growth or return on capital. Now that three annual valuations have been completed this barrier has been removed and the Crown Estate has introduced the following initiatives to assist in the measurement and analysis of its portfolio:

(a) inclusion of the portfolio on an independent commercial databank (the "Investment Property Databank" (IPD));

(b) installation of an in-house property performance analysis system;

(c) engagement of a property research consultant.

2.17 Crown Estate information has been input to the IPD system for the two London agents and the Crown Estate Surveyor, as separate portfolios. These have been analysed separately and compared in terms of structure and performance with all the other portfolios recorded by IPD (representing more than 50 institutions with a total property value in excess of £6.5 billion). The Commissioners consider that although the IPD analysis provides a useful general comparison it is of limited practical application due to the peculiar characteristics of the Crown Estate portfolio.

2.18 The in-house performance analysis system is of potentially greater value in that it provides more detailed analysis down to individual property level. Such analysis allows poor property performers to be
identified and if necessary corrective action to be taken. Although the system was installed early in 1986 the Crown Estate have not yet used it for performance analysis. All the data required for the system to operate has not been input and the Crown Estate has failed to allocate sufficient priority or adequate staff resources needed to obtain a full understanding of its capabilities.

2.19 Property research consultants have been commissioned to produce a five-year forecast for the performance of the commercial estate drawing on information on expected trends by region and sector and applying these to the Crown Estate, taking into account the special features of the portfolio. Preliminary results of this research became available in March 1988. The task has been complex and there have been difficulties in extracting detailed information on the portfolio. The overall method will forecast open-market rental growth and yields up to 1992 and will then relate these to the Crown Estate portfolio which differs greatly from the 'average portfolio' held by investing institutions. These forecasts will be updated on a yearly basis. The Crown Estate consider that this work will substantially assist in measuring achievement.
Part 3: Improvement of the Estate

3.1 During the six years 1981–82 to 1986–87 a total of £230 million was drawn out of the Estate and £270 million reinvested. This substantial activity has been made possible by the impending expiry dates of a large number of leases on fixed rents in the central London portfolio and the general buoyancy of the property market. The money reinvested has been used to improve the existing estate through major developments and to expand the Estate into other areas. There is little sign of this activity slowing down significantly in the foreseeable future. With this level of activity, the proper appraisal of individual investment decisions is of paramount importance. The NAO therefore set out to examine the use of investment appraisal procedures and the overall achievement by the Commissioners in improving the value of the Estate.

Investment appraisal

3.2 As a result of the C&AG’s Report in 1982 drawing attention to inadequacies in the Crown Estate’s investment appraisal techniques (paragraph 1.7) the Crown Estate and Treasury produced revised guidelines for the monitoring of investments. These guidelines covered the two principal types of investment decision open to the Estate:

- the development of new, or redevelopment of existing, property;
- the renegotiation of leases on properties owned by the Estate.

The NAO have examined the guidelines with the assistance of professional advisers, and compared them with those used by other property organizations.

New developments and redevelopments

3.3 The NAO consider that the guidelines are comprehensive and provide the Commissioners with all the information required upon which to base investment decisions. Whilst there are many different procedures adopted by the wide variety of bodies active in the property market the NAO concluded that the structured and formal approach used by the Crown Estate is appropriate for an organisation of its status.

3.4 The NAO examination of a sample of investments showed that although the guidelines were accepted in principle they were not consistently applied in practice. In particular:

(a) there was insufficient evidence available to show that the full range of options open to the Commissioners were always analysed; and some options were only reviewed in a cursory manner. The Crown Estate maintains that all appropriate options had nevertheless been considered by the office and managing agents;

(b) there were no final retrospective appraisals of schemes analysing the financial outcome, comparing it with the initial appraisal and detailing any lessons to be learned;

(c) sensitivity analysis was not always undertaken because the Crown Estate considers that the results would have contributed little in making the decision to proceed or not with the development;

(d) the degree of risk inherent in different options was not clearly identified.

The Crown Estate now plans to review all the appraisal procedures including the use of sensitivity analysis and standard retrospective appraisals.

Lease renegotiations

3.5 The Crown Estate granted many ground leases during the early part of this century for periods up to 99 years at fixed rents. Changes in the property market and high levels of inflation have resulted in these leases having severe disadvantages for both freeholder and lessee. The freeholder is in receipt of only a modest annual rent but can expect substantial future growth in capital value as the lease approaches expiry and full rental value can be claimed. The lessee on the other hand will probably be in receipt of a large profit from sub-letting at current rental values but faces the prospect of the value of his investment disappearing when the lease expires and the property reverts to the freeholder. Both freeholder and lessee may be tied into an outdated property with neither having sufficient interest to finance development. It may well be in both parties’ interest for either the freeholder to buy out the lease or for the lessee to purchase a new modern lease and extend his interest in the property.

3.6 From the Crown Estate point of view an appraisal of a proposal to renegotiate should test:
(a) whether it is more advantageous to renegotiate and gain an immediate increase in rent and probably a capital receipt or wait until the lease expired in anticipation of a larger, but later, increase in rent;
(b) that the benefit of the uplift in value following renegotiation is shared to best advantage with the leaseholder.

The guidelines used by the Crown Estate test both (a) and (b) using Discounted Cash Flow (DCF) techniques and the more traditional surveyor's valuation analysis. The appraisals also take account of other factors, which are not so readily quantifiable such as the benefits of renegotiation on other investments near by. The NAO consider that these procedures are in accordance with best market practice.

3.7 The NAO assessed the extent to which the guidelines had been applied and drew on the expertise of their professional advisers to consider the reasonableness of the assumptions made in a sample of proposals submitted to the Commissioners in 1986 and 1987. This examination revealed that the procedures were being followed although there were some differences in the presentation of information and the level of detail provided.

3.8 In all lease renegotiations assumptions must be made about future rental growth. The higher the assumed rental growth the less attractive renegotiation will be. In all the cases examined by the NAO renegotiation was accepted on the assumption that rental growth would be no more than 6 per cent per annum. Over the last two years rental growth has been considerably higher. The NAO accept that these high levels of growth are, on the basis of historical trends, unlikely to be sustainable in the long term but consider that the growth assumptions in renegotiation appraisals should be subject to regular review. The Crown Estate agree and propose to undertake reappraisals of their decisions at the first rent review following renegotiation to test the validity of the assumptions made.

3.9 One of the most important factors in DCF analysis is the discount rate used. This is effectively the required annual rate of return of the organisation concerned. The higher the discount rate used the more attractive a renegotiation will appear to be. The choice of discount rate was explored by Rodmell who considered the bank base rate, the gilt rate and yield on prime property as possible bases. Rodmell recommended that as the Commissioners could only invest in land the prime property yield was the most appropriate base and recommended that this should be applied in all appraisals. The Commissioners, however, considered that the rates determined by individual agents were more appropriate as these would take into account the special features of the markets within which the Crown Estate operated.

3.10 The NAO examined the appraisals on which DCF analysis had been used since 1982 and assessed the degree to which they reflected market rates. The examination showed that the Crown Estate's rates had been slightly higher than the market rates and had not moved downwards since 1984 in line with market changes. The rate used in 1986 and 1987 by the two London agents was 12 per cent whereas the Crown Estate Surveyor used 14 per cent. Over the same period the gilt rate moved down from 10 per cent to 9.6 per cent and the money return on property remained relatively constant at 10 per cent. The NAO did not consider that the use of a relatively high discount rate had had a significant impact on the decisions on individual proposals but considered that the Commissioners should nevertheless monitor the rate and adjust it in line with changes in market rates.

Estate development

3.11 The major long term strategic investment objective of the Commissioners is the development of the existing Estate to allow it to reach its full potential performance. The programme of development has three principal threads: major developments at Millbank and the Royal Mint; the regeneration of Regent Street; and the redevelopment of smaller sites elsewhere on the Estate. The Commissioners also have an objective to diversify their portfolio. The current budget forecasts that out of total capital expenditure over the period 1987-88 to 1989-90 of £210 million around £100 million will be dedicated to the existing central London estate. Figure 2 shows that redevelopment of the London Estate has absorbed over 60 per cent of available capital so far this decade. The NAO set out to examine the performance achieved in the development of the central London estate and the progress being made to achieve the diversification objective.

Millbank redevelopment

3.12 In the early 1970s the Crown Estate was faced with the problem of either letting the Millbank estate run down further or of proceeding with a comprehensive planned development in cooperation with Westminster City Council. In the view of the Commissioners acting as trustees and not as a property company, piecemeal development would not have been satisfactory nor would the sale of
freehold for unplanned development on the open-market. The 27 acre estate has therefore been under comprehensive redevelopment since 1975 and is due for completion in 1991. To meet the requirements of the planning authorities and to secure a viable operation the redevelopment comprised a mixture of fair-rent housing, market price residential accommodation and office buildings. The Commissioners recognised that the financial return on the commercial elements of the redevelopment would be largely offset by the fair-rent housing but it was considered that its overall economic viability was assured by the office building.

3.13 The last financial appraisal of the Millbank redevelopment, in June 1982, estimated its total cost to date to be £57.6 million with capitalised income at £66.5 million, representing a capital profit of £8.9 million — a return of 15.5 per cent. The appraisal concluded that there were grounds for cautious optimism, although no attempt was made to assess what would be an acceptable return from the completed scheme. Although it provided the Commissioners with some reassurance as to the scheme’s likely financial outcome the NAO noted that:

(a) an 11 per cent financing rate was used rather than the higher government securities rate which averaged 14 per cent over the period covered by the appraisal (1979–1983). The guidelines agreed with Treasury stipulated that the government securities rate should be used. The Crown Estate is reviewing its financing rate as part of its overall review of appraisal procedures;

(b) simple interest calculations were used rather than the more realistic compound interest basis;

(c) the land value for the fair-rent properties was based on an estimated unit price of £2,000 rather than the actual cost of the land, where known. In particular the Thomson House site value was understated by some £0.8 million;

(d) no account was taken of the finance costs on land purchases involving, in the case of the Drummond Gate development, some £1.98 million.

3.14 The NAO examined the financial outcome of four fair-rent housing developments taking into account the additional costs reflected in paragraph 3.13. This revealed a net capital loss of some £10.4 million in respect of the three developments completed at the time of the 1982 appraisal — nearly 100 per cent higher than assessed in 1982. Including the more recent John Islip Street development the NAO estimate the total development loss for the fair-rented projects examined is likely to be £12
million — equivalent to a unit cost of £63,830. The NAO calculate the revenue returns on the four projects to be 2 per cent compared with an 8 per cent rate originally considered reasonable and a 3.5 per cent rate considered likely.

3.15 The Crown Estate recognises that the fair-rent housing was costly, but points out:

(a) The housing was erected on difficult sites which had been built upon previously;
(b) There was considerable inflation in building costs over the construction period;
(c) It was decided that the fair-rent housing should be of similar standard to the commercial development which was planned to take place on the adjacent site. Poor quality would have reduced the value of the whole site;
(d) High quality building leads to lower maintenance costs;
(e) The development of fair-rent housing allowed the release of other accommodation in the area, some of which is now used for commercial purposes.

The NAO consider that many of these factors ought to have formed part of the estimating process and therefore have been included in the original calculation of the likely costs of the fair-rent housing.

3.16 Part of the 350-unit long-lease residential accommodation redevelopment of Millbank includes a 61-unit Crown Reach development carried out in joint partnership with a commercial developer. A joint Committee of Management initially considered an overall capital profit of 30 per cent could be achieved but by June 1980 this forecast fell to 15.7 per cent. In April 1986 an overall loss of £0.9 million was forecast.

3.17 The Crown Reach development was scheduled to take 2.5 years at a construction cost of £5 million but due to complicated building designs; difficulties arising from inadequate co-ordination between the developers and the professional team; changes in market conditions and the need to employ a new project manager, it took nearly five years and is estimated to have cost some £10 million. In June 1984, as a result of differences between the partners regarding sales policy, the Crown Estate purchased the commercial developer's interest in 16 flats at the full market price of over £2.5 million. By the end of 1987 eight of the sixteen flats had been sold, four were under offer and four had been rented out on short-lets to reduce losses.

3.18 The overall viability of the Millbank redevelopment was dependent on the profitability of the office element. In January 1980 Drummond Gate I and II projects were estimated to cost some £38.1 million (6.5 per cent revenue return) and show a capital profit of £11.0 million (31 per cent return). Since then varying estimates have been produced showing revenue and capital returns of up to 7.4 per cent and 4.1 per cent respectively. The NAO estimate that the development has resulted at best in a development profit of £684,000 and at worst a loss of £146,000, representing a maximum revenue and capital return of 6.79 per cent and 1.56 per cent respectively. Between 1982 and 1987 the estimated combined value of Drummond Gate I and II fell from £56 million to £44.5 million in 1987. In March 1988 a long lease for one of the buildings, with a reserved ground rent, was sold for £28.5 million and the other is currently valued at £29.3 million.

3.19 The usual expectation is for professional fees to be between 12.5 per cent and 15 per cent of construction costs. In the case of the successfully completed Drummond Gate II development the fees were 16 per cent of construction costs. For Drummond Gate I and Crown Reach the fees were 26 per cent and 41 per cent of construction costs.

3.20 Although the majority of the Millbank project was completed some time ago the Crown Estate is unable at this stage to quantify the overall profit or loss on the project. It is apparent however that it has been less successful than originally estimated. The NAO found that no attempt had been made since 1982 to appraise retrospectively any element of the scheme. Without such appraisals the Crown Estate cannot identify precise costs, reasons for failures and lessons to be learned for the future.

The Royal Mint development

3.21 The Crown Estate is currently involved in a major joint development of the old City of London Royal Mint site on land which reverted to the Crown Estate in 1969 when the Royal Mint moved to Wales. The main development commenced in 1987 following extensive discussions with the planning authorities, archaeological work on the site and the purchase of some land from the Property Services Agency. Unlike the Millbank development the Commissioners' involvement in the Royal Mint has been limited to planning negotiations and pre-development site work. The Crown Estate has contributed the site (including the parcel of land purchased from The Property Services Agency for £25 million) and paid for archaeological work and site clearance. The development itself is being undertaken by a property development company and funded by an institution.
3.22 Although this means that the rewards from the scheme will be shared with other parties — the Estate receiving only half the annual rental income — it also means that risks are shared and that the development does not place the strain on capital and staff resources that was experienced with Millbank. The development will provide around 434 thousand square feet of office accommodation and is expected to have a value to the Crown Estate in excess of £130 million. By the end of the decade the development will be generating about £8 million a year in rent for the Crown Estate.

Regent Street

3.23 Regent Street occupies a special place in the Crown Estate. It is internationally renowned and provides a focal point for the entire portfolio. In 1982–87 it accounted for 12 per cent of rent and 16 per cent of the value of the portfolio. Since the early 1970s the Crown Estate has adopted a policy of lease renegotiation, partly to improve current income but also to encourage lessees to carry out refurbishment and modernise properties. A report on the Regent Street portfolio indicated that performance gave cause for concern and, in the context of an overriding policy objective of no freehold sales, suggested ways in which it might be improved. This report recommended that long leases should be granted to a number of properties which had already been modernised, and suggested that substantial internal modernisation should be carried out on those properties not considered suited to such leases. The report also focussed on a number of properties in run-down areas — ‘Opportunity Areas’ — where it recommended that leases could be purchased and the buildings totally redeveloped. A start has been made on one scheme at 172–182 Regent Street.

3.24 Since the Commissioners adopted this policy in 1984 more than £35 million has been either spent or committed to Regent Street redevelopment, funded primarily by premiums on lease renegotiations. The NAO note that this policy is consistent with the Commissioners’ duty to maintain and enhance the Estate and is proving successful in not only arresting the decline of Regent Street but also in improving the investment performance of the Estate’s biggest asset.

Portfolio diversification

3.25 The Commissioners’ objective of portfolio diversification aims to prevent, as far as possible, a growing concentration of the value of the Crown Estate in offices and shops in central London and, in particular, the West End. The Commissioners consider that there is a degree of risk in holding almost all their assets in one geographical area, albeit an area which has proved in the past to provide secure long-term growth, and they aim to correct the imbalance. The current geographical and sector distribution of the Crown Estate portfolio compared with other property institutions on the IPD databank shows the Crown Estate’s heavy concentration in London property and its relatively low interest in the industrial sector (Figure 3).

3.26 In the early 1980s as money was being drawn out of the London estate through lease renegotiations a large proportion of it was needed to fund the Millbank redevelopment. When the Millbank cash flow demands subsided in 1984 the Commissioners were able to develop a coherent diversification strategy. This drew on the experience and expertise of the urban Commissioners, their agents and investment advisers and proposed investment of around 40 per cent of the funds in retail property, 40 per cent in offices and 20 per cent in industrial property. No geographical restrictions were placed on retail investment but it was proposed that investment in offices and industrial property should be concentrated in the South and the South East.

3.27 As part of the strategy review this policy was re-examined in 1986–87. The 1984 policy was largely reaffirmed except that greater priority was attached to retail investment, although no target increase was set. The NAO examination of the policy concluded that it was firmly based on the safe investment principle that risk spread is risk reduced. Although individual diversification properties may be more risky than those in central London the overall portfolio risk is reduced by their acquisition. Furthermore the NAO concluded that the policy was in line with the thinking of major property holding institutions and that this was consistent with the Commissioners’ status as low risk investors.

3.28 Some progress has been made on diversification. Over the period 1981–82 to 1987–88 about £129 million out of capital investment of about £367 million was spent on investments in the urban estate outside London. In 1981–82 net income from the urban estate (£0.9 million), was equal to 9 per cent of net income from the London estate and by 1986–87 it had grown threefold to £2.7 million, although that was still only 11 per cent of the total from the London estate. Although further increases can be expected when developments currently in progress are let, urban income is expected to remain a relatively small proportion of London income. Even when completed the Crown Estate does not consider that the diversification programme will radically alter the portfolio balance. Against the apparently limited objectives of the diversification policy and the slow progress in implementing it must be set the
constraints on that policy, particularly the in-built growth on the London estate, the priority accorded to investment in London and the restrictions on the availability of capital.

3.29 To achieve a portfolio distribution more in line with the institutional norm, the Crown Estate would have to commit significantly more funds to the diversification programme. This could only be achieved by drawing more money out of the Estate through increasing the pace of lease renegotiations and selling freeholds. On lease renegotiation the current Crown Estate policy is to wait until approached by a tenant to ensure the best bargaining position. The managing agents have on occasions suggested to lessees in appropriate cases that they should be considering their position in the hope of stimulating an application.

3.30 The pace of renegotiation and the capital value released on each transaction could be increased by extending the lease terms offered or by reducing the amount reserved as annual rent. Until recently the Commissioners have been offering leases for no more than 99 years while the market preference has been for 125 years. The difference in premium on a 125 year compared to a 99 year lease could be in excess of 10 per cent. The Commission have now started to offer 125 year leases although the NAO note that the market is gradually moving towards 150 year leases. A minimum of 10 per cent of rental value is taken as annual rent. A reduction in the rent taken to 5 per cent could increase premiums by around 5.5 per cent.

3.31 Although increased funds from lease renegotiation would give some stimulus to diversification the impact of this alone would only be marginal. To alter radically the portfolio balance would require significant freehold sales in the London heartland. This would only be justified if the existing concentration of assets was considered an unacceptable risk or if new investments outside London were likely to achieve a significantly better return than existing properties. The Commissioners do not consider that either of these criteria apply.

**Borrowing powers**

3.32 The more actively the Commissioners manage the portfolio the more important the absence of borrowing powers becomes (paragraph 1.5). The three independent reports produced since the last PAC hearing have all recommended the introduction of at least some limited borrowing powers.

3.33 The arguments put forward for the introduction of borrowing powers suggest that they
would allow a reduction in the level of liquid capital reserve; avoid the need for forced sales in a depressed market; and prevent the need to share profit with developers. The Crown Estate has held a large pool of liquid capital in gilts (generally offering a lower return than property investments) as insurance against the possibility of overspends on development and as a source of funds for investment in attractive propositions coming on the market unexpectedly. There were occasions when the Commissioners were forced to sell in a depressed market to fund the Millbank development, although this was partly the result of poor financial planning.

3.34 The Crown Estate has argued that the absence of borrowing powers imposes a strict but necessary financial discipline in that it makes the Commissioners more prudent in their decision making and reduces the risk of major errors. In essence the granting of borrowing powers would give the Commissioners greater freedom and flexibility and allow them to act more in the manner of a commercial operation. It would, in effect, allow the Commissioners to use their substantial asset base as collateral to obtain external funding in order to gear up their balance sheet for the purpose of maximising financial returns.
Part 4: Estate Performance

4.1 The Commissioners have the statutory responsibility to maintain and enhance the value of the Estate and the return from it but with due regard to the requirements of good management. As valuations of the Estate were not undertaken before 1985 it was not possible to analyse the extent to which this responsibility had been discharged. However, since then the 31 March valuations have increased from £899 million (1985) to £962 million (1986) and £1,200 million (1987) — an increase over the two years of 33 per cent. From 1987-88 the value of the Estate will be shown in the balance sheet of a revised form of accounts and this will allow measurement of return on capital and capital appreciation.

4.2 The Crown Estate has also been set the financial target of achieving an annual revenue surplus — the Exchequer contribution — at least equal in real terms to that achieved in 1977–78. Table 3 records the gross rents collected increasing by 94 per cent from 1981–82 to 1986–87 with the contribution to the Exchequer increasing by 114 per cent over the same period. Figure 4 shows that the contribution to the Exchequer has increased significantly in real terms. At current prices the target equates to about £12 million. The contribution in 1986–87 was £30 million with further potential waiting to be released on the London estate which could increase the surplus to around £55 million by 1997.

4.3 Figure 5 shows the extent to which each of the individual sectors contributed to the return from the Estate. The NAO set out to examine by sector whether the performance matched that achieved in the property market generally.

The London and urban estate

4.4 The London and urban estate provides the commercial backbone of the portfolio. Rents on the estate have grown significantly over the last six years (Table 4), with the renegotiation of leases which had been on rents fixed early in the century and the letting of new developments. The heartland estates of St James’ and Regent Street have contributed in excess of £5 million per annum in additional rents during the 1980s from lease renegotiations and reversions. Individual rents have increased on renegotiation, for example from £8,000 to £350,000 on one lease, and at the same time capital premia of up to £6.5 million have been drawn out for reinvestment elsewhere. New developments have been let, funded in a large part by the heartland premia, which now generate rents in excess of a further £5 million per annum. These include the Millbank development which produces £3.5 million per annum, the development of property on Wardour Street and the diversification portfolio.

4.5 The NAO compared rental growth on the Crown Estate London and urban portfolio with published

Table 3

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<td>Rents</td>
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<td>35.4</td>
<td>38.8</td>
<td>45.4</td>
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<td>Net surplus</td>
<td>14.2</td>
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<td>21.7</td>
<td>21.9</td>
<td>25.6</td>
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<td>16.0</td>
<td>19.0</td>
<td>23.0</td>
<td>26.5</td>
<td>30.0</td>
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Table 4

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<td>15.8</td>
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<td>25.1</td>
<td>30.5</td>
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Figure 4

Crown Estate contribution (actual and at 1986-87 prices) 1961-62 to 1986-87

- Actual
- 86-87 Prices
- Treasury agreed target

Year

Contribution £ millions

Figure 5

Crown Estate revenue surplus by estate sector 1981-82 to 1986-87

Year

Surplus £ millions

81-2 82-3 83-4 84-5 85-6 86-7

Windsor/Forest Misc F/Shore Agric Urban London
market indices. Whereas the Crown Estate showed growth over six years in excess of one hundred per cent the various indices recorded figures between 40 and 50 per cent. Although this shows the Estate to be outperforming the market, the comparison should be treated with some caution. The peculiar features of the Crown Estate portfolio make meaningful comparisons difficult. No other major institution has had such a large proportion of its properties tied up on leases at fixed rents determined up to sixty years ago and to a large extent the Crown Estate rental growth is a catching-up exercise.

4.6 Only two years data are available to calculate total return (revenue return plus capital growth) as the Estate was not comprehensively valued before March 1985. The total return was 16.5 per cent in 1985 - 86 and 30.4 per cent in 1986 - 87. These figures include the fair-rent housing properties, and if these are excluded the return increases by around one percentage point. Published indices of commercial property returns over the same period average around 7 per cent in 1985 - 86 and 10 per cent in 1986 - 87. This simple comparison is based on accounts data. More refined figures relating only to commercial properties were prepared for the Crown Estate by IPD for the calendar year 1986 and can be compared with the performance of other portfolios on the databank (Table 5).

| Total return 1086 calendar year |
|-------------------|-----------------|-----------------|
| Total return | Capital growth | Revenue return |
| % | % | % |
| Crown Estate | 22.4 | 17.5 | 4.9 |
| IPD | 8.8 | 2.2 | 6.5 |

4.7 This shows that the Crown Estate performance has been heavily dependent upon capital appreciation, the revenue yield being lower than the market average. The principal reason for this is the high proportion of leases still on low fixed rents.

4.8 The unique lease structure on the London estate makes it difficult to assess whether or not the high growth rates and high return on the portfolio can be viewed as good performance. There are no external comparators against which the Estate’s performance can be measured, other than in the broadest terms, and historically there have been no internal targets.

4.9 The NAO considered that the peculiar nature of the Estate made the development of internal targets an urgent necessity to facilitate rational performance measurement. For this reason the NAO welcome the current exercise being undertaken by agents on behalf of the Crown Estate to forecast return on the commercial portfolio over the next five years. In advance of the agent’s report the NAO have made initial assessment of the possible growth in annual revenue from the commercial estate over the next ten years. The NAO consider that even assuming no market growth and no active management by the Crown Estate the rents on the commercial estate can be expected to increase from the 1987 level of £32 million to £53 million by 1992 and £59 million by 1997. This ten year growth is calculated on the basis of a further £14 million from known lease reversions in London and £13 million from developments already funded. Actual growth will not follow this pattern as some leases will be renegotiated before reversion and capital premia taken rather than full annual rent. Nevertheless, assuming that the market does not fall and that premia are only taken for reinvestment in property with at least as good a revenue return then the projection should provide a reasonable indication of the minimum return which can be expected over the next ten years.

The Agricultural estate

4.10 Reviews of performance across the agricultural estate are made difficult by the fact that it encompasses a wide variety of farming types on different qualities of land throughout Britain. The Crown Estate has only recently begun to collect statistics on the financial performance of individual estates.

4.11 Investment in agricultural land is subject to more severe statutory constraints than investment in commercial property. The relationship between the landlord and tenant is governed by agricultural holdings legislation which covers matters such as rent, security of tenure and respective responsibilities for expenditure. The level of rents is governed by farmers’ income. The growth in rents on the Crown agricultural estate over the last six years is shown in Table 6.

4.12 Table 6 shows growth at a steadily decreasing rate reflecting the combined effects of the changes in the agricultural economy and the impact of an extensive improvement programme now coming to completion. The Crown Estate agricultural branch produce a detailed analysis of rents which identifies changes from one rent review to the next taking into account inflation and expenditure on improvements. The most recent analysis shows a failure to maintain
Table 6

Agricultural rental growth 1981–82 to 1986–87

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<tr>
<td>Rents (£000)</td>
<td>6,950</td>
<td>7,800</td>
<td>8,600</td>
<td>9,300</td>
<td>9,650</td>
<td>9,950</td>
</tr>
<tr>
<td>Rents per acre (£)</td>
<td>25.9</td>
<td>29.5</td>
<td>32.6</td>
<td>34.6</td>
<td>36.0</td>
<td>36.9</td>
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Table 7

Relationship of net to gross revenues (£000)

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<tr>
<td>Gross receipts</td>
<td>6,900</td>
<td>7,800</td>
<td>8,600</td>
<td>9,200</td>
<td>9,900</td>
<td>9,950</td>
</tr>
<tr>
<td>Net</td>
<td>4,400</td>
<td>4,700</td>
<td>5,850</td>
<td>6,100</td>
<td>6,800</td>
<td>6,300</td>
</tr>
<tr>
<td>Percentage</td>
<td>64</td>
<td>60</td>
<td>68</td>
<td>66</td>
<td>69</td>
<td>63</td>
</tr>
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</table>

in real terms the rents achieved at the previous review at all but three of the last eleven rent review dates carried out over the last 5.5 years. The NAO compared the rent increases achieved by the Crown Estate with data produced by the Ministry of Agriculture, Fisheries and Food which suggested that the Crown Estate had fared no worse than other agricultural investors.

4.13 Over recent years agriculture has become a less attractive source of investment for the institutional investor and the relatively low returns and poor medium term growth prospects have led to a decline in capital values. Over the three years the Crown Estate has been valued, acreage has remained broadly unchanged but the value has fallen, in line with market changes, by almost a third from £200 million to £138 million. Falling capital values and low revenue yields have produced a negative total return of −12 per cent in 1985–86 and −15 per cent in 1986–87. Despite this the Commissioners have made a policy decision to retain the agricultural estate at broadly its current acreage on grounds that the Crown has always had an extensive agricultural estate, but also so that they do not sell in a buyers market. Other landowners are taking a different view and reducing their holdings although this is often out of the necessity of meeting short term commitments.

4.14 With rents either static or falling and a decision to retain the estate control over costs becomes increasingly important. Table 7 shows the net to gross revenue relationship excluding in-house management costs (estimated to be about £0.5 million). Repairs and maintenance have been between 17 and 22 per cent of rents with payments to agents at around 10 per cent.

4.15 The Crown Estate has recognised the need to control repairs and maintenance costs by setting a norm of 10 per cent of rents in 1980. The limited comparative information from the Church Commissioners' accounts of 11.5 per cent and 9 per cent of rent in 1985 and 1986 respectively tend to support the Crown Estate figure. The NAO noted that repairs and maintenance costs over the last six years have exceeded 10 per cent by £4.5 million. Although repairs and maintenance represented 18 per cent of rent in 1986–87 Crown Estate projections show a steady reduction in the proportion in future years.

The Windsor estate

4.16 Windsor Great Park is not a commercial venture and has always been a financial liability. The Crown Estate objective towards Windsor has been to minimise net expenditure insofar as this is consistent with the statutory duty to maintain the character of the estate as a royal park and forest. The revenue deficit on the estate in 1986–87 was £1.9 million and at 1986–87 prices has been around £2 million throughout the decade. Attempts have been made to control the deficit through the minimisation of expenditure and maximisation of revenues. The estate staff costs represent the major element of expenditure; with 270 directly employed workers Windsor accounts for some 45 per of the entire Crown Estate staffing.

4.17 Expenditure has been controlled over the last five years primarily by reducing staffing levels by 10
per cent through natural wastage. On revenue, management has sought to increase earnings on the estate from commercial gardens, a shop and restaurant and car parks. Although efforts are continuing to be made to raise revenue these are unlikely to have a significant impact on the estate deficit as the opportunity for introducing new activities is constrained by the requirement to maintain the character of the estate. On the capital account there is little potential for productive investment. Most of the expenditure incurred during the 1980s has been on a programme of improvements to estate workers’ cottages at a cost of some £6 million.

Capital and Revenue Returns

4.18 Under the 1961 Act the Commissioners are required to distinguish between capital and revenue in their accounts and make proper adjustments where applicable for recouping capital expenditure from revenue. The distinction between the two accounts is important as all net revenues are surrendered to the Exchequer whereas capital is retained within the Estate for investment. Because of this distinction there may be some conflict of interest with the Estate benefiting more from high capital growth and the Exchequer more from a high revenue yield. The total return on the Estate was 18.5 per cent in 1986–87 and 12.7 per cent in 1985–86, capital appreciation accounting for 84 per cent and 79 per cent respectively. Superficially this may suggest a preference for capital over revenue but the split should be seen in the context of the Estate structure and movements in the main markets in which the Estate operates. Capital growth will tend to be high because of the concentration of assets on fixed leases in the London heartland. Revenue yield will be low for the same reason and as a consequence of the presence of non-commercial elements in the portfolio such as the Windsor estate and fair-rent housing.

4.19 In their examination of investment appraisal the NAO considered whether or not the appraisal or subsequent decision indicated any preference for capital over revenue. There was no evidence that this was the case. As a general rule the Estate does not invest in properties with a high initial yield, and consequently a high potential risk. Instead the aim is to select safe properties with secure long term growth potential, an approach which is consistent with the Commissioners’ status as trustees.
The Structure of the Crown Estate

The Crown Estate comprises:

**The London Estate** — a mix of commercial, office, retail and residential properties concentrated in the West End of London and four fair-rented housing estates. It is currently valued at approximately £900 million and produces a net annual income of some £20 million. Considerable recent growth in the capital value and income return from the London estate is the result of the general buoyancy of the London property market; the renegotiation of old leases with low fixed rents; and the redevelopment of a number of important sites. The value by main locations is:

<table>
<thead>
<tr>
<th>Location</th>
<th>Value (£m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regent Street</td>
<td>190</td>
</tr>
<tr>
<td>City</td>
<td>107</td>
</tr>
<tr>
<td>Lower Regent Street</td>
<td>88</td>
</tr>
<tr>
<td>Kensington</td>
<td>87</td>
</tr>
<tr>
<td>St James</td>
<td>82</td>
</tr>
<tr>
<td>Regents Park</td>
<td>80</td>
</tr>
<tr>
<td>Millbank</td>
<td>73</td>
</tr>
<tr>
<td>Victoria Street</td>
<td>66</td>
</tr>
<tr>
<td>South Pall Mall</td>
<td>55</td>
</tr>
<tr>
<td>Wardour Street</td>
<td>43</td>
</tr>
</tbody>
</table>

**The Urban Estate** — principally commercial properties outside London valued at a little over £100 million. The estate is a combination of the historical Crown Estate provincial portfolio and the new diversification portfolio which the Commissioners have recently been developing. The old provincial portfolio is concentrated around Windsor and Ascot with a number of small holdings around the South of England. A large proportion of the properties are residential. The diversification portfolio is a recent creation originating from the Commissioners’ desire to redress the balance of the overall portfolio and in particular the concentration in the West End of London. The 1987 value of the diversification portfolio was £55 million.

**The Agricultural Estate** — the historical core of the Crown Estate comprising almost 270,000 acres (64 per cent in England and 36 per cent in Scotland) some 600 tenancies, a capital value of £137.5 million with rents totalling £9.8 million. The estates vary in size from less than 2,000 acres to more than 10,000 acres and cover a wide variety of types of farming including hill grazing, dairy, cereals and root crops. The Estate is run on a traditional landlord and tenant basis with no farming in-house. After expenses the estate made a net revenue contribution of £5.1 million in 1986-87.

**The Windsor Estate** — land within the area of the Windsor Park and Windsor Forest. The Commissioners have a duty to maintain its character as a royal park and forest and may not sell or exchange any land unless it is in the public interest and can be replaced by adjacent land. As a result of statutory restrictions, the proximity of the Sovereign’s principal residence outside London, and the public’s rights of access for recreation, it is not possible to run the estate at a profit. In 1986-87 it was operating at a net revenue loss of some £2 million.

**The Forestry Estate** — ten separate forestry estates valued at over £11 million. It is viewed as a long term investment and in 1986-87 made a net revenue loss of £330,000.

**The Foreshore Seabed and Minerals Estate** — currently valued at £37.4 million, is one of the unique features of the Crown Estate. Ownership includes 55 per cent of the foreshore around the coast of Britain: all the seabed within territorial waters: and the right to explore and exploit the continental shelf outside territorial waters. Ownership excludes the rights to gas and oil which rest with the Department of Energy, and to coal, with British Coal.