NATIONAL AUDIT OFFICE

The Department for Culture, Media and Sport

The Re-negotiation of the PFI-type deal for the Royal Armouries Museum in Leeds

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL
HC 103 Session 2000-2001: 18 January 2001

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John Bourn **National Audit Office**
Comptroller and Auditor General **4 January 2001**

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Appendices

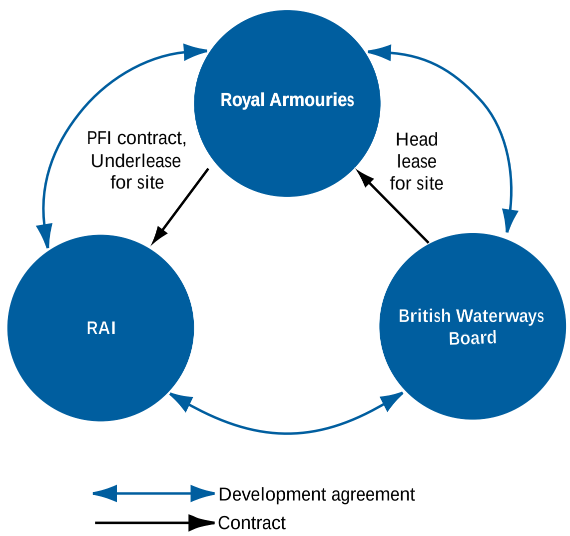
executive summary

In this chapter

1 In December 1993 the Royal Armouries ("the Armouries"), then based principally in the Tower of London, signed a contract with a private sector company, Royal Armouries (International) plc ("RAI"), for a new museum in Leeds to display more of its collection. Under the contract RAI were to build and operate the new museum. In return it would retain all the income the museum generated from visits by the public. The contract structure for the deal is shown in **Figure 1**. However the new museum never made enough money to meet its operating costs and the servicing of RAI's debts. Consequently in July 1999, after previous warnings from RAI's bankers, the Bank of Scotland, that it would not be able to make additional funding available to RAI after that month if RAI's financial problems persisted, the Armouries revised its agreement with RAI. Under the revised agreement the Armouries took over responsibility for the running of the museum, while RAI retained responsibility for the provision of some services, such as catering, to visitors to the museum. RAI is to use its income from these activities to pay off its debt with the Bank. A chronology of events is at Appendix 1.

2 The deal with RAI in 1993 was one of the very first PFI deals signed. At the time there was no guidance available to the Armouries and its sponsoring department[1] (the Department) on how to structure such deals nor was there much experience within government and in the private sector. We therefore considered whether current guidance on good practice on PFI deals would have strengthened the Armouries' and the Department's position in coping with RAI's financial problems and the threat which these posed to the museum's continued operation. We also examined whether, despite the existence now of comprehensive guidance on the PFI, there were any lessons which could be learned from this particular deal for future contracts. The methodology we adopted is set out in Appendix 2.

1 Contract structure 1993-1999



Source: National Audit Office

1 *The Armouries' sponsoring department was the Department of Environment until 1992 when the newly created Department of National Heritage took over responsibility. In 1997 this department was renamed the Department of Culture, Media and Sport.*

The deal for the establishment of a new museum in Leeds

3 The Armouries decided to proceed in 1990 with the establishment of a new museum as it considered that this would help it to meet its statutory duties by allowing it to put more of its collection on display. The profits from the new museum would also allow it to meet its strategic business objective of becoming more financially self-sufficient by reducing its need for grant-in-aid from the Department (paragraphs 1.9 to 1.11).

4 The agreement the Armouries signed with RAI in December 1993 generally met the specific objectives that the Armouries set for the project. For example, it enabled both the public and private sectors to make a financial contribution to the project and share in its returns. RAI met over £14 million of the £43 million cost of constructing the new museum, with the Armouries contributing £20 million and Leeds City Council and Leeds Development Corporation £8.5 million. While RAI was to retain, in most instances, any profits the museum made, the deal also provided the Armouries and RAI with a share of any future development gain from the redevelopment of the surrounding Clarence Dock site. The Armouries also consider that the deal maximised the private sector's contribution as its financial advisers, Schroders, told it that, in their opinion, the deal with RAI was the best that could have been achieved in the market at the time, given the project's parameters. The competition for the deal, however, elicited little response. Despite the Armouries' marketing of the deal to the private sector, it received only one serious proposal, from RAI (paragraphs 1.17 to 1.24).

5 The deal involved a major transfer of risk to the private sector. RAI was to build the museum in accordance with the Armouries' design and then operate it for 60 years. During the museum's operation RAI would receive no further public funding except for the free provision by the Armouries of its curatorial staff and a contribution by the Armouries to the museum's marketing and promotion costs. RAI was to meet all other operating costs from the income generated at the new museum and retain any profit made. This was a significant commercial risk for RAI as the museum was a new attraction with no proven track record of visits by the public and this was RAI's only source of income. RAI accepted this risk by heavily discounting the projections of visitor numbers and by engaging Gardner Merchant to manage the early launch phase. For its part, the Armouries retained ownership of the collection and full responsibility for its maintenance and preservation (paragraphs 1.25 to 1.31).

6 The museum was delivered on time in March 1996 and to budget. Once opened it won a number of national and international awards and achieved high levels of visitor satisfaction. However, it also immediately began to incur losses and by early 1999 RAI's cumulative losses were estimated at £10 million. These losses arose as visitor numbers were much less than previously estimated **(Figure 2)**. Delays in the development scheme for the surrounding Clarence Dock site also contributed to RAI's financial problems as these delays, in turn, meant delays in its receipt of its share of the development gains and a lack of passing trade for the museum (paragraphs 1.33, 1.35, and 1.41 to 1.45).

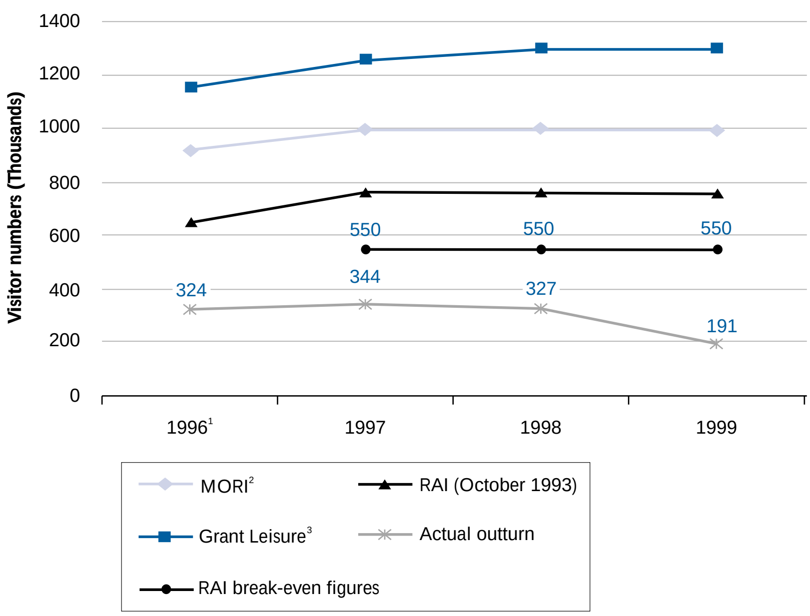
7 In the face of these financial problems, RAI's steps to increase its income and reduce its expenditure resulted in some disagreements with the Armouries over RAI's actions and performance. The early settlement of these disagreements could not be informed by an agreed operating specification which lay down the agreed requirements and standards of performance in operational areas, such as income generation and the maintenance of the museum by RAI. Under the 1993 contract the Armouries and RAI were to agree the specification before the museum opened but in 1994 they agreed to defer this until after the opening as they believed that they would need to acquire some experience of operating the new museum first. In fact the specification was never agreed and the settlement of the disagreements proved more difficult because of the financial difficulties in which RAI found itself and the unpredictability of visitor numbers (paragraphs 1.29 and 1.46 to 1.50).

8 In response to its financial problems RAI undertook two refinancings with the support of both its shareholders and its lenders, the Bank of Scotland. However, as part of the second refinancing in 1998 the Bank said that it would not be able to make additional funding available to RAI after July 1999 if its financial problems persisted (paragraphs 1.52 and 1.54).

9 Both the Armouries' and RAI's ability to deal with the problems at the museum was limited by some of the terms of the 1993 deal. The lack of an agreed performance regime with pre-agreed service standards, monitoring arrangements and provisions for the contract's termination in the event of RAI's poor performance made it difficult for the Armouries to address effectively those areas of RAI's performance, such as income generation and the maintenance of the museum, which were in dispute. However there is no evidence that this had any significant effect on visitor numbers. RAI's ability to cut certain operating overheads was limited and, due to Treasury's stipulations, no additional funding was available to the Armouries to make further contributions to the museum's operating costs beyond those contributions to, for example, marketing and promotion costs agreed as part of the original deal.

2 **Visitor numbers**

Visitors numbers were much less than expected.



Notes: 1. April to December 1996.
2. Excludes school visits and foreign tourists as the estimates are based on a survey of the UK adult population.
3. Includes school visits and foreign tourists.

Source: Royal Armouries

Because RAI was a private company the Armouries also faced great difficulty in getting timely information on the true extent of RAI's financial difficulties as, under the contract, it had no access to RAI's underlying financial records (paragraphs 1.51 and 1.55 to 1.61).

10 The provisions of the 1993 contract also meant that, in the event of RAI going into receivership, the Armouries could not immediately terminate the contract and take possession of the museum. If it wanted to take over the museum's operation without a period of delay it would have to come to a financial arrangement with RAI's main creditor, the Bank of Scotland. As no attempt was made to negotiate on this basis, it is not clear as to the size of the payment that the Bank would have required. However the size might well have been affected by the fact that, under the terms of RAI's sub-lease of the museum from the Armouries, the buildings could only be used as a museum and had to be kept open to the public at all reasonable times (paragraphs 1.66 to 1.71).

11 The Armouries and the Department considered a number of options for dealing with the financial crisis. The most expensive option was to persist with the 1993 contractual structure with the Armouries funding RAI's continuing losses from increased grant-in-aid. The cheapest options involved the closure or partial closure of the museum after RAI went into receivership. However the Armouries' evaluation of non-financial factors scored these options poorly. The Armouries' preferred option was for it to take over all the museum's operations with RAI remaining in a shell company role, although this would have required the agreement of RAI and its principal lender, the Bank of Scotland. On the basis of advice from the Armouries' legal advisers, the Armouries and the Department considered that, if RAI was to go into receivership, it was unclear whether and to what extent the receiver would keep the museum open, notwithstanding the restrictive covenants in RAI's sub-lease of the museum. If the museum were to close, then the Armouries' compliance with its statutory duties would be adversely affected, as far fewer items of the collection would be on display. The Clarence Dock development scheme would also be adversely affected. Also, if the museum were to close, the Armouries might need extra grant-in-aid either to pay for new accommodation to display the collection elsewhere or to pay off RAI's creditors in order to gain immediate access to the existing buildings. Another important factor was that the political impact of the loss of a national museum, particularly one in the north, would have been considerable (paragraphs 1.70 and 1.74 to 1.81).

12 Following consultation with the Bank of Scotland, RAI made a late proposal under which the Armouries would take over responsibility for the museum, with RAI providing certain services to the public at the museum. The Department supported these proposals. It considered that this was the only arrangement which was certain to keep the museum open as this was the only option that RAI's bankers would support. It also considered that RAI's proposals offered better value for money; they were marginally cheaper than the option the Armouries preferred, which involved no role for RAI and the Armouries taking over total responsibility for the museum and all the services there, and offered a similar level of non-financial benefits. Finally, the Department preferred these proposals as RAI would retain responsibility for the repayment of its loans with the Bank of Scotland of almost £21 million (paragraphs 1.85 to 1.88).

13 Consequently, in July 1999 the Department told the Armouries that RAI's proposals were the only ones for which the Department was willing to make extra funding available (paragraph 1.89).

14 Under the revised deal reached in July 1999 the Armouries has taken back certain risks which were previously allocated to RAI. The Armouries now operates the museum and meets its operating costs, in the first instance, from the income the museum generates. The Armouries has therefore assumed the demand risk that visitor numbers are insufficient to ensure the museum's future survival. In addition to the income from the museum, the Armouries also receives from the Department extra grant-in-aid of £1 million a year. However this has been insufficient to meet all the extra costs that the Armouries now incurs from running the museum and the Armouries has had to make efficiency savings of almost £2 million a year. In addition the Armouries and Department have identified measures which could help to increase visitor numbers (paragraphs 1.90 to 1.92, and 1.101).

15 RAI has retained responsibility for the provision of catering, car parking and corporate hospitality at the museum. It is possible that it may get enough income from visitors from these activities to ensure, once it has paid off its debt with the Bank of Scotland, that its investors will see some return on their investment. Should, however, RAI go into receivership, the Armouries' position in the new museum is protected (paragraphs 1.93 to 1.94, and 1.97).

16 The revised deal has brought the Armouries benefits. The museum has remained open with a fully trained operational workforce. The revised deal has also ensured the survival of the Clarence Dock development scheme, from which the Armouries will receive a number of benefits such as the free provision of further storage space for its collection. The museum's continued operation retains and, through the Clarence Dock development, creates a number of benefits for the local economy and community (paragraphs 1.107 to 1.110).

Comparison with current practice

17 The Armouries' deal was one of the very first PFI projects and took place when there was no guidance available on how to structure such deals. Since the signing of this deal in December 1993 the PFI has developed greatly. Many more such contracts have been signed and there is a large body of guidance now available to public bodies who want to enter into such deals. Consequently developments in the PFI have made a similar outcome on other PFI projects less likely. The Armouries cannot be criticised for any failure to follow subsequent guidance as the issue is whether current best practice would have led to a better outcome if it had been available at the time.

18 For example, it is unlikely that a similar project would be approved now without a clearer demonstration of value for money. The importance of an effective competition when awarding a PFI contract is now emphasised. On this project there was little interest in the market place (paragraph 4). There is also now a requirement that a public sector body prepare a public sector comparator, showing the cost of providing the required services using public funding, and compare this with the PFI option before signing any contract. No such comparator was prepared for this deal as the Department had decided in 1991 that the new museum should not be totally funded by the public sector but that some funding should come from the private sector (paragraphs 2.3 to 2.4).

19 Had this project been concluded in line with guidance which became available subsequently, it seems likely to us that the Armouries would have been better able to tackle the problems on this project. For example, guidance now recognises the need for an agreed performance regime which was lacking on this project (although there is no evidence to suggest that the lack of this specification here had a material effect on the number of visitors). Greater rights of access to the private sector party's financial records, as is now standard, might have helped the Armouries to determine the extent of any financial problems being encountered by the contractor on this project. The existence of a direct agreement, as recommended in current guidance, would have placed the Armouries in a better position to discuss with RAI's bankers RAI's financial problems as such an agreement would have established a direct contractual relationship between the Armouries and the bankers. More significantly, current guidance, if followed, would have given the Armouries the right to terminate the contract and take possession of any assets provided under the contract immediately the contractor went into receivership, again unlike on this deal (paragraphs 2.8 to 2.10, 2.12, and 2.17 to 2.20).

20 The incorporation of the elements of current good practice in the original 1993 contract would probably not have saved this deal in the face of a collapse in visitor numbers. However, in our opinion, it seems likely that these elements would have allowed the Armouries to intervene more easily and at an earlier stage. This earlier intervention may have opened up more opportunities for saving the deal as options which were not considered to have been feasible in 1999 may have been in 1997 (paragraphs 2.28 to 2.29).

Recommendations

Extent of market interest

1 When procuring PFI projects, it is important that departments should gauge the level of market interest. If, as on this project, the project is inherently risky, because of the lack of proven demand, and there is very little interest in the project as currently structured, departments should consider whether to continue with the project or to restructure it to make it more likely that a greater number of private sector firms will compete for the contract. A department could amend the scope by seeking a deal for the delivery of serviced accommodation, where payments to the private sector party are dependent on the accommodation's availability. Alternatively, a department could revise the risk allocation and share demand risk, by agreeing, for example, to a revenue guarantee mechanism whereby the department will provide some financial support to the private sector party if demand falls below an agreed level.

Completeness of contractual documentation

2 Departments should ensure that the contents of all contract documentation, such as the operating specification as well as the contract itself, are agreed before the contract is actually signed. Agreements to agree provisions after contract signature severely weaken the public sector's negotiating position when it comes to agree these terms subsequently. After contract signature the public sector body will not easily be able to walk away from the project if it seriously disagrees with the private sector party's proposals in the areas under negotiation as it will have to comply with any provisions contained in the contract regarding the contract's termination.

Compliance with current good practice

3 Departments should seek to comply with current good practice and guidance when procuring PFI contracts. The experience on this deal demonstrates that the availability of such guidance when this contract was awarded would have improved the Armouries' and the Department's position when faced with the financial difficulties of its private sector partner and the possible closure of the museum.

Termination in the event of contractor insolvency

4 When faced with the possible insolvency of a private sector partner on a PFI project, departments should, as was done in this case, consider all options open to them, including the possibility of not intervening and allowing the insolvency to occur. As in this case, departments should be absolutely clear what their position is legally under the contract should the private sector partner actually become insolvent. They should establish what rights they have to terminate the contract and take possession of any related assets, and their consequent liability to the payment of any compensation sum.

Part 1

The new deal meets the revised objectives for the project but transfers some risks back to the public sector

1.1 In December 1993 the Royal Armouries ("the Armouries") signed a contract with a private sector company, Royal Armouries (International) plc ("RAI") for a new museum in Leeds to house the majority of the Armouries' collection. Under the contract RAI were to build and operate the new museum and, in return, would retain all the income generated from visits by the public. The new museum was delivered on time and to budget. However it never made enough money to meet its operating costs and RAI faced the prospect of becoming insolvent in July 1999. Consequently in July 1999 the Armouries revised its agreement with RAI and took over responsibility for the running of the museum.

1.2 This Part therefore examines whether the establishment of the new museum was consistent with the Armouries' long-term business strategy, how RAI's financial problems arose, whether the terms of the original deal aided the resolution of this financial crisis, what options the Armouries and its sponsoring department[2] (the Department) considered to tackle the crisis, and what the terms were of the revised deal made to save the museum.

1.3 It shows that the Armouries considered that the establishment of a new museum at Leeds was consistent with its long-term strategy and that the deal the Armouries reached with RAI in 1993 to provide this was generally in line with the specific objectives that the Armouries had set for the project. Once it opened in March 1996 the museum immediately began to make losses, principally because visitor numbers were less than expected. In 1998 RAI's lenders, the Bank of Scotland, warned that it would not be able to make additional funding available to RAI after July 1999 if its financial problems persisted.

1.4 The Armouries' ability to deal with RAI's financial problems was limited by some of the terms of the original deal. However the Armouries and the Department considered a number of options for tackling the financial crisis, including allowing RAI to go into receivership and the Armouries taking over total responsibility for the museum. In the end the Department told the Armouries that it would only make additional funding available for an option proposed by RAI under which the Armouries would take over the museum but RAI would continue to have a limited role.

1.5 The revised deal transfers risks back to the Armouries, including the risk of admissions, delivers efficiency savings in the running of the museum, and reduces the amount of additional grant-in-aid from the Department that would otherwise have been required. The Armouries' ability to generate income is restricted to a certain extent as, under the revised deal, RAI retains the income from catering, corporate entertainment and car parking.

A new museum in Leeds was part of the Armouries' long-term strategy

The Armouries saw a new museum as a way of meeting its strategic objectives

1.6 Under the National Heritage Act 1983 the Board of Trustees of the Armouries was established in April 1984 and is responsible for a National Museum of Arms and Armour. The Board's functions are financed primarily by annual grant-in-aid from the Department. The grant for 1999-2000 was £4.1 million, subsequently increased to £5.1 million. The Permanent Secretary of the Department is the Accounting Officer for the appropriation account from which the Armouries' grant is paid. The Permanent Secretary has designated the Master of the Armouries, a post established by statute, as Accounting Officer for the Royal Armouries.

2 *The Armouries' sponsoring department was the Department of Environment until 1992 when the newly created Department of National Heritage took over responsibility. In 1997 this department was renamed the Department of Culture, Media and Sport.*

1.7 The National Heritage Act 1983 lays down a number of statutory duties with which the Armouries must comply **(Figure 3)**. In line with these duties the Armouries' mission is to promote in the UK and world-wide the knowledge and appreciation of arms and armour and of the Tower of London through its collections and the expertise of its staff. In addition the Armouries has an operational objective of becoming more financially self-sufficient in the long-term.

1.8 Until 1993 the Armouries' operations were based at the Tower of London and Fort Nelson (near Portsmouth). In 1990 the Royal Armouries agreed a development strategy, "Strategy 2000", for the future exhibition of its collection of arms and armour, based on the construction of a new museum. To this end in 1991 a search was held to select a site for the new museum. The criteria for selection included the financial support available from the local authority, the location and size of the city, and the proposed site itself. In June 1991, having considered a number of alternative locations, the Trustees selected the Clarence Dock area in Leeds as the site for the new museum **(Figure 4)**. The museum was to be the centrepiece of the redevelopment of a previously industrial and commercial 15 acre waterfront site, which lay within the boundaries of the Leeds Urban Development Area. In addition to the new museum, the redevelopment would provide office space, a hotel, shops, and restaurants. A major factor in selecting the Leeds site was the financial contributions of £5 million from Leeds Development Corporation and £3.5 million from Leeds City Council, which were to be provided on the basis of the regeneration benefits the new museum would bring.

1.9 The Armouries' strategy in seeking a new museum was designed to improve its ability to meet its statutory duties. A new museum would allow it to exhibit the collection to the public and promote the public's enjoyment and understanding of arms and armour, by putting more of its collection on display. The Armouries' collection had been on public view at the Tower of London since the 1600's. But space constraints only permitted around 5,000 items, about ten per cent of its collection, to be exhibited. At the same time there was a proposal to relocate the Jewel House within the Tower of London, which required the Armouries to vacate some of its existing accommodation.

1.10 The Armouries also considered that a new museum would allow it to meet its objective of becoming more financially self-sufficient. Grant to the Armouries had been steadily reducing in line with the Department's policy of making heritage bodies more self-sufficient. At the time, in line with other museums, the existing facilities at the Tower were loss-making and the Armouries was receiving grant-in-aid. The Armouries expected that the new museum would be a successful visitor attraction of national and international standing with state of the art presentation techniques. The surpluses from this new museum could therefore help reduce the Armouries' need for grant-in-aid.

1.11 The Armouries was supported in this expectation by studies which showed that it could move from a requirement for grant funding to the making of a surplus through the establishment of a new museum in Leeds. For example, J Henry Schroder Wagg & Co. Limited (Schroders), the financial advisers appointed by the Armouries to develop a form of public/private sector partnership for the project which would maximise private sector involvement and finance, reported in May 1992 that there was a strong financial case for the project to be undertaken. The Armouries would benefit from the potential revenue from the Leeds operation, as well as from the increased revenue at the Tower of London which would arise from the improvement in tourist facilities by the Historic Royal Palaces Agency which could only occur once the Armouries had moved some of its operations to Leeds. Schroders forecast that the project would generate net revenue of £4.2 million a year, although the Department would have to make an up-front contribution of £20 million, half of the estimated costs of construction of the new museum.

1.12 Later in 1992, the Department commissioned further advice on the commercial viability of the new museum. It commissioned MORI to undertake an appraisal of ticket price strategy and expected visitor numbers, and then Grant Leisure to validate the visitor numbers and assess the museum's income potential. Both studies indicated that the operation of the museum, once open, would be commercially viable.

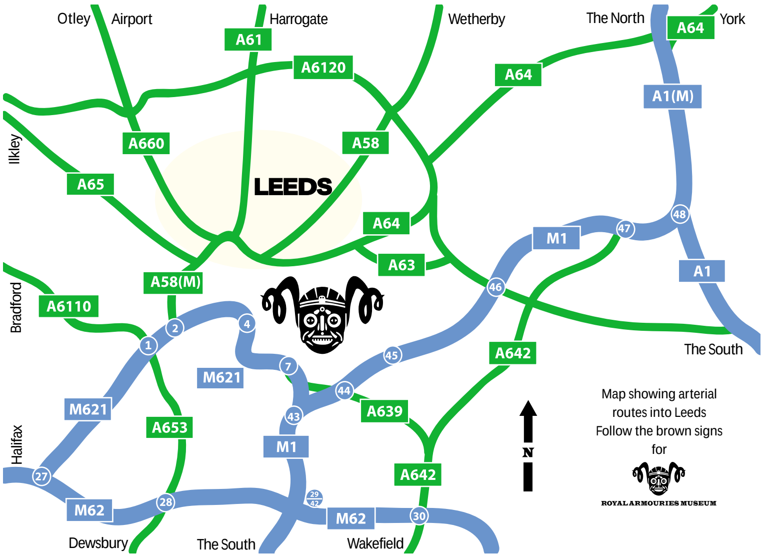
3 The Royal Armouries' statutory duties

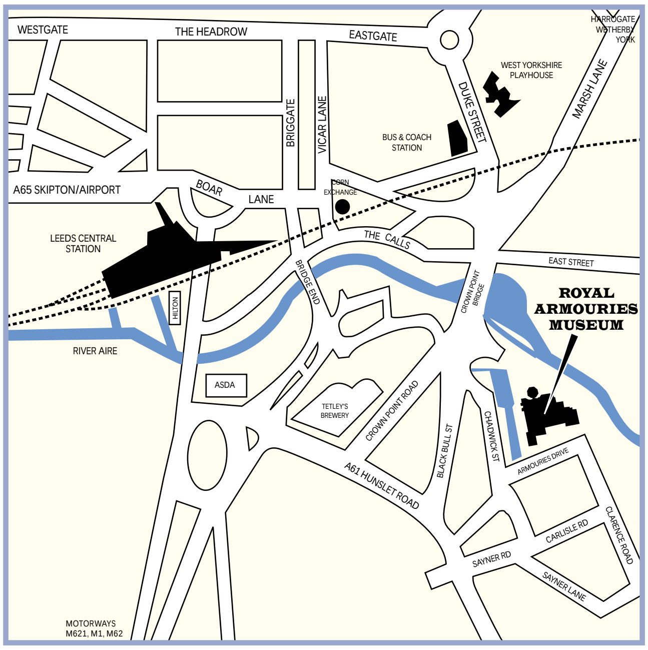
The National Heritage Act 1983 imposes a number of statutory duties on the Royal Armouries.

- To care for, preserve and add to the objects in its collection of arms, armour and associated objects
- To secure that the objects are exhibited to the public
- To secure that the objects are available for inspection or research
- To maintain records of the collection
- To generally promote the public's enjoyment and understanding of arms and armour

Source: National Heritage Act 1983

4 The museum's location





This photograph appears by kind permission of The Board of the Armouries.

The Armouries' objectives for the project were in line with its strategic objectives

1.13 The Armouries' objectives for the deal are given in **Figure 5**. These reflected the need to implement a strategy which made the Armouries more self-sufficient financially and reduced its requirement for grant, at the same time as delivering a new museum which would allow the Armouries to increase the proportion of its collection which was on show to the public.

1.14 The Armouries included amongst its objectives for the project that of the provision of a mechanism for both the public and private sectors to make a financial contribution to the project as the Department had required in June 1991 that some of the funding for the new museum should come from the private sector. Also, studies that the Armouries had commissioned stated that it was unlikely that the new museum could be wholly privately financed. Schroders reported in May 1992 that, although the project would generate net revenues once it opened, the rate of return would be too low for the project to be funded wholly by private finance, and it would require a substantial contribution (estimated at over £19 million) from the public sector. Because there was no track record of joint public-private sector ventures involving museum or other heritage developments, the private sector would require a clear commitment by the public sector to provide funding. As a result in July 1992 the Treasury approved a contribution of £20 million towards the construction and fitting out of the museum. There was to be no additional, revenue funding.

The 1993 agreement generally met the project's objectives

1.15 The Department, the Armouries and their advisers had discussions with a bidder led by 3i Group plc, leading to the signing of an agreement in December 1993 which established a joint venture between the Armouries and RAI. Responsibilities of each party in the joint venture are shown in **Figure 6** and the contract structure in Figure 1.

5 The Royal Armouries' objectives for the project

The Royal Armouries set a number of objectives for the new museum project.

- To provide a mechanism for the public and private sectors to make financial contributions and allow for the sharing of returns
- To achieve the maximum risk transfer to the private sector
- To obtain maximum private sector funding
- For the construction and operation of the new museum to be under private sector control
- To enable the Royal Armouries to maintain control over the curatorial and heritage components of the project

Source: The Royal Armouries

1.16 As part of the deal the Trustees acquired the museu site and the area immediately surrounding it under a 999 year head-lease from the owner, British Waterways Board. Under this lease rent of £185,000 a year became payable to the British Waterways Board from the opening of the museum, rising to £625,000 a year after 40 years. The Armouries, in turn, sub-let the museum site to RAI for 60 years from the opening of the museum. Under the sub-lease, RAI reimbursed the Armouries for the annual rental payable to the British Waterways Board.

1.17 The agreement which the Armouries negotiated met strategic aim of getting a new museum in order to display more of its collection. The agreement also met most of the objectives it set for the project. In particular: it permitted the Armouries and RAI to deliver their financial contributions to the project, and allowed both parties a share in the future development gain; it transferred a substantial amount of risk to the private sector; the construction and operation of the museum were largely under private sector control; and the Armouries retained control over the activities relating to its statutory functions, including care and maintenance of the collection.

Under the agreement the Armouries got a new museum to display more of its collection

1.18 Under the agreement RAI were to build the new museum according to the agreed design and operate it for 60 years. The Armouries would consequently get access to a new museum of 218,000 square feet, of which 138,000 were to be used for displays, exhibits and ancillary public facilities, such as a restaurant. The new museum enabled the display of almost 8,000 objects from the Armouries' collection, an increase of sixty per cent on the previous number of items on display (paragraph 1.9). It also provided better access for research by students, visitors and academic experts, and improved environmental conditions for the storage of the collection.

The agreement allowed the public and private sectors to make financial contributions and receive a share of any returns

1.19 The agreement permitted the Armouries and RAI to deliver their financial contributions to the project. RAI raised £14.1 million of private funding for the project, while the Armouries contributed £20 million to the estimated development costs of approximately £43 million. There were further contributions from Leeds City Council and Leeds Development Corporation with a total value of £8.5 million. The public and private sector sources of funds, and the uses to which those funds were put, are shown in **Figure 7 overleaf**.

6 Responsibilities of the parties: 1993 to 1999

Responsibilities for the new museum were split between the public sector and the private sector but rested mostly with the private sector party, RAI.

Public Sector Responsibilities	Private Sector Responsibilities	Joint Responsibilities
Construction phase		
■ Contribute grant of £20 million towards construction costs ■ Obtain contributions from Leeds Development Corporation (£5 million) and Leeds City Council (£3.5 million) ■ Design the display of the collection ■ Pack and unpack the collection ■ Lease the site for the new museum for 999 years from the existing owner, the British Waterways Board, and sub-let to the private sector for 60 years [1]	■ Let a fixed price contract for the construction of the museum and manage this ■ Contribute over £14 million to the cost of construction and fit-out ■ Procure the displays for the collection according to the Armouries' designs ■ Procure the removal of the collection to Leeds	
Operational phase		
■ Pay the agreed lease rental to the British Waterways Board from the opening of the museum ■ Provide the major part of the collection for exhibition in the new museum ■ Acquire new items for the collection ■ Provide Royal Armouries' staff to care for and maintain the collection, and deliver interpretative, education and research services ■ Meet the on-going costs of existing Royal Armouries' staff who transfer to Leeds to care for the collection	■ Under the sub-lease, reimburse the Royal Armouries for the annual rent payable to the British Waterways Board ■ Let an operating contract to a main operator to manage the commercial aspects of the new museum in accordance with the operating specification ■ Provide the Armouries with facilities at the new museum to allow it to fulfil its statutory duties, including secure storage, space for library, education centre, and office facilities, at no cost to the Armouries ■ Fund the museum's operating costs from the receipts from visitor income and other income sources, including car parking charges, retail, catering, corporate hospitality and sponsorship income, and manage the commercial aspects of the museum for a period of 60 years ■ Make an annual payment to the Royal Armouries to reimburse the Armouries for the costs of the extra staff the Armouries needed to take on as a result of the establishment of the new museum ■ Make provision for the security of the collection to a standard agreed in the operating specification ■ Maintain the building and fixtures and fittings for the period of the agreement in accordance with the operating specification	■ Draw up an agreed operating specification before the museum opened ■ Jointly undertake and finance the promotion and marketing of the new museum in accordance with the operating specification
Development of Clarence Dock		
		■ Approve the development scheme for the rest of the leased site ■ Share in the net profit from the development

Note: 1. Once the development agreement becomes active, the Armouries' 999 year lease on part of the site lapses, although the Armouries has the right to resume the lease on this land after the development period.

Source: 1993's contract documents

7 Source and use of project funding

The cost of constructing the new museum was met from a number of different sources of funding, both private and public sector.

	£ million	£ million
Uses of funds		
Construction and fitting-out costs	34.4	
Marketing, relocation, professional fees and pre-opening expenditure	5.5	
Interest and contingency	2.7	
		42.6
Sources of funds		
Royal Armouries	20.0	
Leeds Development Corporation	5.0	
Leeds City Council	3.5	
Private finance: equity and subordinated debt	8.0	
: debt	6.1	
		42.6

Source: The Royal Armouries

1.20 The agreement allowed the Armouries a limited share in any future profits that RAI made from the museum operations. These profits were to be retained by RAI in the first instance as it had accepted a high level of risk under the deal. However, if the number of visitors increased above 1.3 million, there was provision for the Armouries to share in the extra income achieved. The agreement did not expose the Armouries in the first instance to downside risk if profits were less than expected at Leeds, or if the museum made operating losses. The Armouries also still expected to benefit financially from the improvements to the tourist facilities in the Tower that would take place once the Armouries had relocated some of its operations to Leeds.

1.21 The deal also provided the Armouries and RAI with a share of any future development gain from the surrounding Clarence Dock site. Under an agreement with the British Waterways Board, the owners of the site's freehold, both the Armouries and RAI were to share in any profit which arose from the development of that part of the Dock site which the Armouries leased, while RAI were due to receive further development gain arising from that part of the Dock site not leased by the Armouries.

The Armouries' advisers considered that the deal maximised the private sector's contribution to the project

1.22 During 1991 and 1992 the Armouries, with advice from Schroders, had considered a number of options for involving private finance in the project, including sale and leaseback and a limited partnership. Options, such as the public sector taking an equity share in the project, or a wholly privately funded scheme, were rejected because they were not judged to be sufficiently attractive to the private sector or would have required a change in the legislation governing the Armouries' operations. In February 1993, on the advice of Schroders, the Armouries and the Department chose to seek the new museum on the basis of a straightforward contractual relationship with an up-front contribution of £20 million from the Department.

1.23 We cannot say conclusively whether the Armouries obtained maximum private sector funding, because the Armouries only received one serious proposal for the new museum. Once the joint venture structure was decided, Schroders attempted to market the project to potential providers of private funding. In March 1993 they issued a briefing memorandum to a number of potential investors, including leisure groups and financial institutions. Only two potential bidders showed interest in the project. The Tussauds Group undertook some feasibility work, but withdrew in June 1993 because they were not convinced that private and public objectives for this project could be reconciled and they thought the visitor projections too optimistic. Their own projections were much lower and did not allow for a satisfactory return. The other potential bidder, 3i Group plc, a venture capitalist, was, however, willing to act as lead investor. Discussions continued with 3i Group and in summer 1993 a Chairman and Chief Executive for the project vehicle were appointed.

1.24 Faced with only one bid for the project the Armouries and Department took some comfort from Schroders' opinion in November 1993 that the deal with RAI was the best that could have been achieved in the market at the time, given the project's parameters.

The agreement allowed the transfer of much risk, with the construction and operation of the museum under private sector control

1.25 The agreement concluded in December1993 transferred considerable risk to the private sector. The allocation of key risks under the 1993 agreement is shown in **Figure 8**.

1.26 The deal transferred construction cost risk to the private sector partner. The Armouries had already designed the museum, obtained planning permission, committed £5 million of expenditure, and commissioned tenders for the construction of the museum before its joint venture partners were appointed. Under the agreement RAI was responsible for constructing and fitting out the museum within the agreed budget of approximately £43 million and building the museum to the agreed timetable. Thus the risk of cost and time overruns during the construction and fitting out phase was transferred to RAI. The agreement also allowed for the Armouries to receive a share of any saving on the construction cost in proportion to its contribution of £20 million. A fixed price construction contract was awarded following competition to Alfred McAlpine Construction Ltd, who was jointly selected by the Armouries and RAI. Construction started in January 1994 and the museum opened on time, and within budget, in March 1996.

1.27 The deal also transferred the commercial risks of operating the museum to the private sector partner. The original agreement provided that RAI should operate the museum with no funding from the Armouries, apart from the provision of certain professional and support staff by the Armouries and the joint undertaking and funding by the Armouries and RAI of the promotion and marketing of the new museum. RAI was solely responsible for funding the operating costs of the museum, including core museum functions such as interpretation, education, security, together with the costs of maintaining the museum building and displays (Figure 6). The only sources of income available to RAI to meet these operating costs were visitor income, car parking charges, retail and catering income, sponsorship and corporate hospitality - and RAI's potential future share in development gain. RAI could not rely on income from other projects to help support this venture.

1.28 As the museum was a new attraction in a redevelopment area, there was no proven "footfall", and therefore there was considerable risk associated with the income projections. Grant-in-aid to the Armouries from 1996 onwards did not include any separate element for the continued funding of the Leeds museum. The agreement therefore passed all the commercial risk to RAI, in line with the objective established by the Armouries of transferring maximum risk to the contractor. RAI told us that it had recognised this risk. Its business plan had therefore relied on heavily discounting the projections of visitor numbers (paragraphs 1.11 and 1.12). It had also engaged Gardner Merchant, an experienced facilities management company, to manage the early launch phase.

1.29 The project agreement provided for the Armouries and RAI to reach agreement before the new museum was to open on many detailed operational matters where the Armouries' and RAI's interests and responsibilities overlapped, through the drawing up of an operating specification. This specification was to cover matters such as the number of Armouries' staff required to fulfil its statutory functions, the standards of repair and maintenance for the museum and its fixtures and fittings, and the arrangements for jointly undertaking and funding the promotion and marketing of the museum. Agreement on this specification was never, however, reached. This was partly because the Armouries and RAI agreed in 1994 that, in order to obtain practical experience in operating the new museum before determining the specification and to make way for the accelerated design and construction of the building, they would defer the agreement of this specification until after the museum's opening. However the main reason for the lack of agreement was the financial difficulty in which RAI found itself once the museum was open and its resulting concern not to do anything which might increase its costs in the face of reduced income. Consequently, despite the encouragement of the National Audit Office in 1997 and the Department in 1998 and the Armouries' own efforts, it proved impossible for the Armouries to agree an operating specification with RAI.

The Armouries retained ownership of the collection and continued to provide curatorship of the collection

1.30 Under the agreement the Armouries retained the collection, but agreed to make it available for display in the museum, while retaining the right to lend items of the collection or organise travelling exhibitions. It retained full responsibility for maintenance and preservation of the collection and, in consultation with RAI, decided which items of the collection were to be displayed and how they were to be presented. Some 17 of its staff were relocated to Leeds to carry out these responsibilities and its other statutory duties, with RAI making a contribution of £196,000 to their relocation costs. These staff remained Armouries' employees and their employment costs were met by the Armouries itself.

8 The allocation of key risks in the original agreement

The contract transferred considerable risk to RAI.

Risk	Responsibility	Comment
Planning, design and development risks	Royal Armouries	The Royal Armouries had selected the site, designed the museum, and obtained planning permission before RAI was awarded the concession. The Royal Armouries' preferred design was reflected in the building contract.
Cost overruns on construction and fitting-out of the museum	RAI	The risk of cost overruns associated with the further development of the design, and the construction and fitting out of the museum lay solely with RAI as the Department's financial contribution was capped at £20 million, and limits were also placed on the contributions from the other public sector bodies.
Operating cost and revenue risks	RAI	The risk of operating costs and revenues being different from those projected lay solely with RAI. The agreement did not allow for the Royal Armouries to make any contribution to operating costs, apart from funding some staff costs associated with their statutory functions.
Financing risk	RAI	RAI was responsible for raising and repaying private finance.

Source: 1993 contract

1.31 The agreement also allowed for the Armouries and RAI to agree on any additional staff the Armouries needed to employ as a result of the establishment of the new museum. The cost of these staff would be met by RAI via an annual payment to the Armouries for their services.

There were additional external benefits

1.32 Schroders' study in May 1992 identified that, in addition to the benefits that the new museum would bring the Armouries, there would be other, external benefits to Leeds and the surrounding area, arising from the regeneration involved. However these external benefits were not quantified as planning permission for the redevelopment scheme had not been granted at the time. Also, the establishment of a new Armouries' museum in Leeds allowed the Historic Royal Palaces Agency to benefit from the redevelopment of the accommodation vacated by the Armouries in the Tower.

The continued operation of the museum was threatened by a financial crisis

RAI soon ran into financial and operational difficulties

1.33 Once opened the museum won a number of national and international awards and its ratings for visitor experience, as awarded by its visitors, were high. However RAI's business plan in August 1993 had forecast operating revenues of £6.8 million in 1996, rising to £12.4 million in 2000, with annual profits increasing in the same period from £1 million to £2.6 million. In fact once the museum opened, RAI's trading activities at the Leeds site were not sufficient to cover its costs and service its debt, with operational revenues considerably below target. Consequently RAI made increasing annual losses. In early 1999 these were forecast to reach cumulatively almost £10 million by 31 December 1999 **(Figure 9)**.

1.34 RAI faced other difficulties in the operation of the museum. RAI had intended that it would simply be a financial vehicle for the project and would contract the operation of the museum to one of its equity investors, Gardner Merchant. However at the end of 1996 Gardner Merchant withdrew from the operating contract by mutual agreement. RAI consequently accepted 200 of Gardner Merchant's staff on their previous terms and conditions and took on the role of operator as well as joint venture partner.

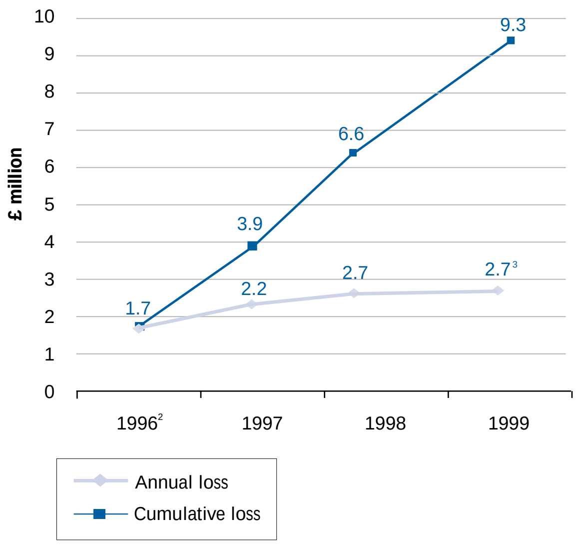
The financial difficulties were caused by lower than expected visitor numbers

1.35 The main reason for the museum's operating deficits since its opening was the failure to achieve the expected levels of ticket revenue. In RAI's business plan projections in August 1993, ticket revenues were expected to be £3.4 million, rising to £3.9 million by 1999. Actual revenues were only £1.4 million in 1998, falling to £800,000 by 1999.

1.36 Failure to achieve the planned levels of revenue from ticket sales was due to much lower than expected visitor numbers. In May 1992 Schroders had assumed almost 1.3 million visitors when assessing the financial viability of the proposed museum. This figure for visitor numbers was based on earlier projections prepared in 1991 by PA Consulting and MORI. Based on these figures and assumptions about income from other sources such as sponsorship, special functions, museum services, and car parking fees, Schroders had forecast a net cash flow, after allowing for maintenance and debt servicing costs, of £2.8 million in the first year of operation, rising to £4.3 million by 2005. This gave a rate of return to investors on the original investment required to fund the construction and fitting out of the museum of 25 per cent over 25 years.

9 RAI's losses[1]

RAI incurred losses from the museum's opening and continued to do so.



Notes: 1. Figures are for RAI's operating losses after interest.
2. 1996's loss was incurred from April to December 1996.
3. Forecast loss. The actual loss for 1999 was £5.5 million, resulting in total cumulative losses of over £12 million, after a large, one-off increase in depreciation to reflect a reduction in the value of RAI's fixed assets.

Source: Royal Armouries (December 1998)

1.37 Schroders also tested the impact on the investor's rate of return of visitor numbers in the range 750,000 to 1,500,000. They concluded that, if visitor levels were as low as 750,000, the project would still achieve a rate of return of 14 per cent. Schroders did not examine the impact of visitor levels below this figure. On the basis of this advice, the Department and the Armouries concluded that private sector operation of the museum was a viable proposition.

1.38 This high level of visitor numbers was generally confirmed by other studies. The August 1992 MORI study commissioned by the Department estimated that, based on a sample of 1,500 people across the country, the new museum would receive almost one million visits a year. The September 1992 study by Grant Leisure forecast 1.1 million visits a year on opening, rising to 1.3 million by 2000 and increasing thereafter.

1.39 RAI's own estimates of visitor numbers were lower than those produced by MORI and Grant Leisure for the Department, and were considered conservative by RAI (paragraph 1.28). The base case in RAI's August 1993 business plan had assumed that the museum would achieve a level of 900,000 visits in its first full year of operation. In October 1993 RAI revised its estimates downwards to reflect independent analyses commissioned by the two firms which were, at that time, competing to join RAI as the museum operator. Based on these analyses, RAI estimated that the museum would receive about 760,000 visits a year. For the museum to break even, it would need 550,000 visits a year. Independent research commissioned by RAI in 1995 from MEW confirmed that visitor numbers were likely to exceed this break-even point.

1.40 The only other private sector company to express an interest in the project, the Tussauds Group, who had a great deal of experience in running a major tourist attraction, withdrew their interest in June 1993 as, amongst other things, they considered that the forecast of visitor numbers prepared in 1992 for the Armouries and the Department was very optimistic and could not be realised, and their own forecasts were a great deal lower.

1.41 From the start of operations, however, visits to the museum have been considerably below the levels forecast by the Department's and Armouries' consultants, and by RAI (Figure 2). The break-even level of visitor numbers identified by RAI has not been reached in any year. The level of visits to the museum was around 63 per cent of the break-even level in the first full year of operation, and had fallen to 35 per cent by 1999. The shortfall is due to a number of factors including the lack of passing trade due to the delay in the development of the Clarence Dock area and to national stagnation or decline in museum visits.

Delays in the Clarence Dock redevelopment also contributed to RAI's financial difficulties

1.42 The new museum was intended to be the focal point for the development of the Clarence Dock site. In December 1993 the Armouries and RAI had entered into an agreement with the British Waterways Board as to what would happen should the dock site around the museum be developed as planned. This agreement included the sharing of the development gains arising, worth potentially several million pounds. However there was a delay in the development scheme and therefore in the Armouries' and RAI's share of the proceeds from the development. The British Waterways Board, Armouries and RAI did not select a developer for the site until July 1997 when they accepted a proposal from Berkeley Group. Under this proposal Berkeley Group would pay £13.4 million for a leasehold for the undeveloped part of Clarence Dock, eventually agreed at 150 years, which would then be shared by the three parties. Negotiations with Berkeley Group then took longer than expected.

1.43 After the selection of Berkeley Group there were disagreements over the exact share of the proposed disposal proceeds of £13.4 million between the British Waterways Board, Armouries and RAI. Also, the Armouries had a number of conditions and requirements which it wanted the development scheme to fulfil. These included the construction of a museum extension of 40,000 square feet to provide an exhibition hall and further storage for the collection. The exhibition hall was required, in the Armouries' view, because it did not have control over the use of the exhibition hall in the existing museum. This further space would be funded by Berkeley Group, at an estimated cost of £2.8 million, in lieu of the Armouries' share of development gain. The Armouries also sought the provision by Berkeley of a further 30,000 square feet for expansion (later reduced to 12,500 square feet). The Armouries sought this additional space in response to a request by Berkeley Group that the length of its lease for part of the dock site be 150 years, longer than had originally been proposed. The Armouries therefore wanted the additional space to enable it to cope better with the loss of this land for a longer period than expected.

1.44 After much negotiation the amount of storage and expansion space that Berkeley eventually agreed to provide free to the museum will be less than the Armouries originally sought as the total development proceeds due to the British Waterways Board, Armouries and RAI will be less than first expected because of increases in the costs of preparing the site for development.

1.45 Further delay of over a year arose as planning approval was sought for the proposed development to proceed. Approval was not obtained until February 2000 and the development agreement with Berkeley, which would provide RAI with its revised share of development gain, was not entered into until March 2000, after the financial crisis and renegotiation of the agreement with RAI. Consequently RAI was unable to use its share of the development gain to help resolve its financial difficulties as it had envisaged within its business plan.

RAI faced constraints in boosting its income

1.46 Co-operation between the Armouries and RAI was essential to the success of the project. There were a number of significant areas where income generation by RAI required the Armouries' co-operation **(Figure 10)**. The details of such matters where co-operation was required, such as income generation, was to be provided by the operating specification. This specification was to set down the agreed standards by which RAI would market the new museum. It would detail the Armouries' requirements on the display of the collection, the promotion and marketing of the museum, merchandising, and the admissions policy. Although the specification was to be agreed before the new museum opened, it never was (as explained at paragraph 1.29).

1.47 In the face of its financial difficulties RAI attempted to boost its income. For example, it mounted a programme of commercial exhibitions, holding four such exhibitions in two years and thus increasing its income in this area to almost £500,000 in 1998, six times RAI's original forecast. RAI was also successful in increasing the income from corporate hospitality to £1.3 million in 1998, sixty per cent more than forecast and almost the same amount as raised from admissions (paragraph 1.35). RAI also increased ticket prices.

10 **Income generation**

The Royal Armouries and RAI had to co-operate in a number of areas of income generation.

- The Royal Armouries decided, in consultation with RAI, what items from the collection were to be displayed and how
- The Royal Armouries could loan items of the collection to other institutions, after consulting with RAI
- Promotion and marketing were to be undertaken and financed on a jointly agreed basis
- RAI were to find sponsorship for the new museum in consultation with the Royal Armouries
- RAI were to take the lead in any future joint business opportunity but this opportunity had to be in accordance with the Royal Armouries' statutory duties

Source: 1993 contract

1.48 Various tensions arose between the Armouries and RAI over the operation of the museum, particularly RAI's attempts to boost its income. Disagreement included the level of payment RAI should make for the services provided by the Armouries and vice versa; the emphasis given to corporate hospitality by RAI; ticket pricing policy; the approach to marketing the museum; and control over the use of the exhibition hall and the appropriateness of the exhibitions held by RAI.

RAI also faced difficulties in reducing its costs

1.49 In an attempt to reduce its costs RAI introduced operational efficiencies based on the experience it had gained in operating the museum since its opening in 1996. This facilitated a reduction in its operational staff in July 1997 from 215 to 120. It also reduced its expenditure on the marketing of the museum in the expectation that the museum had established itself in the market place after almost two years of operation. As the marketing and promotion of the museum were jointly financed by the Armouries and RAI (paragraph 1.27), the Armouries' own annual contribution to this expenditure also fell from £250,000 to £150,000. This reduction in marketing expenditure concerned the Armouries as it considered that more marketing was needed if visitor numbers were to be increased. Although the Armouries jointly staffed and financed the museum's marketing and was involved in the decisions about the marketing budget, it told us that it viewed itself as the junior partner and that, as RAI had assumed the risk of operating the museum under the 1993 contract, RAI should have the final say on these matters. RAI, for its part, told us that it did not consider that it had the final say.

1.50 The Armouries was also concerned that RAI's financial difficulties would mean that RAI would be unable to maintain the museum and its displays adequately. According to the Armouries RAI did reduce its maintenance expenditure below the level that the Armouries considered was required to maintain the museum and its exhibitions. RAI however disputes that it allowed the condition of the museum to deteriorate.

1.51 RAI's ability to cut operating overheads where they related to core museum functions relating to the Armouries' statutory duties, such as education and interpretation, was limited. Therefore, in late 1997 RAI asked the Armouries to consider funding some of the museum operational overheads associated with education and library services, interpretation, and security of the collection, totalling over £600,000 a year. The Armouries said that it was willing to discuss the re-negotiation of the 1993 contract that this request would entail. However it first wanted more details of RAI's financial performance before reaching any agreement.

RAI initially obtained extra funding from its banks but only until July 1999

1.52 The result of the operating losses was that RAI was unable to meet capital or interest payments on the main loan provided by Bank of Scotland of £8.4 million, which was repayable by 2003. Early in 1997, therefore, RAI undertook a restructuring of its debt, drawing £7.15 million under a subordinated loan facility provided by its shareholders. In July 1998 the Bank of Scotland agreed a further refinancing.

1.53 Security for the original loan of £8.4 million to RAI and for the further refinancings had been provided in part by a fixed charge over the leasehold property, that is the museum building itself. The existence of such a charge gave the Bank the right to take possession of the charged asset and arrange for its disposal in order to secure the repayment of its outstanding loans. However the museum building was not owned outright by RAI but was leased from the Armouries (paragraph 1.16). Consequently the Bank, and any subsequent purchaser of the lease, would be bound by the provisions of this lease, including any restrictive covenants contained in this.

1.54 As part of the 1998 refinancing the Bank of Scotland stated that it would continue to make funds available to RAI on a normal commercial basis until 31 July 1999. However it also stated that it would not be able to provide additional funding beyond this date if a solution to RAI's financial problems had not been found by then. The availability of this funding allowed RAI to continue operating as a going concern but only until 31 July 1999. Withdrawal of the Bank's support on that date would then have resulted in RAI becoming insolvent.

The Armouries' ability to deal with the financial crisis earlier was limited due to the provisions of the original deal

The agreement did not tie RAI down to a clear performance regime

1.55 The agreement envisaged that, before the museum opened, the Armouries and RAI would agree an operating specification, which would contain, amongst other things, agreed details on the performance to be expected from RAI in terms of income generation and the maintenance of the new museum. However this specification was never agreed (as explained at paragraph 1.29).

1.56 RAI's difficult financial position, coupled with the lack of agreement of this specification, made early resolution of the disputes that arose about income generation (paragraph 1.48) difficult as there were no agreed standards or requirements with which RAI's measures to increase its income had to comply. The failure to agree the specification also made it impossible for the Armouries to demonstrate that RAI's level of maintenance of the new museum was contractually unacceptable and therefore required resolution, as the Armouries claimed and RAI refuted (paragraph 1.50). The Armouries and RAI never agreed on a budget for maintenance work, the programme of work to be carried out and the maintenance standards that RAI was to meet. There were therefore no contractual benchmarks against which RAI's performance could be measured. However the alleged poor maintenance was not material to the severe reduction in visitor numbers which was the main cause of RAI's financial difficulties.

1.57 Arrangements for monitoring RAI's performance were also lacking. As required by the agreement an operating committee, made up of representatives from the Armouries and RAI, was established and met regularly to discuss major strategic and operational issues, including RAI's performance. Visitor exit surveys were also held. However the agreement gave no details of how RAI's performance in meeting the contractual requirements would be monitored and against what criteria and targets that performance would be assessed. There was therefore a lack of agreed data about RAI's actual performance on such matters as maintenance and income generation. Thus, for example, although the Armouries considered that RAI were spending less than the Armouries felt was necessary to maintain the museum and its exhibits adequately, the Armouries never had any information on the level of RAI's actual expenditure. In December 1997 the National Audit Office told the Armouries that, in its opinion, the Armouries was unable to report effectively to its Board on RAI's performance.

1.58 In addition, the Armouries' ability to terminate the contract for poor performance was limited. The agreement only allowed the Armouries to terminate the contract for poor performance by RAI if RAI committed a fundamental breach of the contract. It did not identify any agreed, specific level of poor performance under the operating specification which constituted such a breach. It would therefore have been difficult for the Armouries to terminate the contract for poor performance by RAI. It would also have been very difficult to find a replacement company who would have been willing to operate the museum on the same terms as RAI, given the reduced level of visitor numbers.

The Armouries could not contribute to the museum's operating costs

1.59 As a condition of its approval of the project in July 1992 the Treasury stipulated that there would be no additional funds available for the project apart from the original £20 million contribution to the budgeted cost of approximately £43 million for constructing and fitting out the new museum. The £20 million contribution was to be wholly financed from additional visitor revenues at the Tower of London which would arise from the construction of the new exhibition centre for the Crown Jewels and improvements to the facilities for tourists.

1.60 The 1993 agreement did not envisage that the Armouries would provide any contribution to the operating costs of the museum, except for promotion and marketing. Recognising that there were considerable "downside" risks, the Treasury had agreed to the new museum in July 1992 on the basis that there would be no additional funds available for the project from the Department. This condition meant that, if the Armouries were to provide any contribution to the operating costs of the museum, this would have to be met from their existing grant allocation. Consequently the Armouries had limited scope for providing a contribution to museum operating costs when it became clear that the original revenue projections were not being achieved.

The Armouries' access to RAI's financial information was limited

1.61 The Armouries was aware that RAI was in financial difficulties. It knew that visitor numbers were lower than expected and that RAI had made staff redundant in 1997. The Armouries also learned of the refinancing by RAI in 1997 soon after it occurred. However the Armouries had difficulty getting information on the exact extent of RAI's financial difficulties. Although the Armouries did receive information on daily visitor numbers and spend per head and copies of RAI's annual accounts when published, it had no rights of access to RAI's underlying financial records and no rights under the contract to be informed of financial difficulties. The Armouries only became aware of the actual extent of RAI's financial difficulties in September 1997 when RAI's annual accounts for 1996 were made available to them. Access to the annual accounts was of limited use as these only gave the historical position. The Armouries had no access to RAI's business plans with its forecast of RAI's future performance and RAI's strategy for dealing with its financial problems. Nor did the Armouries have access to RAI's management accounts which showed RAI's financial performance across the whole of its business. Consequently, when attempting to identify RAI's likely future performance in 1998 and 1999, the Armouries and the Department had to rely to a great extent on their own estimates.

1.62 In view of RAI's financial difficulties in December 1997 the National Audit Office, as the Armouries' external auditors, suggested strongly to the Armouries, amongst other things, that the Armouries should consider a clear risk assessment of all available options, with the benefit of robust, critical input from advisers with appropriate project finance skills and experience, to help safeguard its position. In particular this assessment should consider whether the proceeds from the Clarence Dock redevelopment would be sufficient to solve these difficulties and, if not, what risks the Armouries faced in the medium term.

1.63 In response, the Armouries commissioned in early 1998 a review from Schroders of the risks associated with the joint venture, with and without the potential development agreement for Clarence Dock. Using information supplied by RAI, this review examined the future financial viability of RAI and the consequences if RAI failed. Schroders reported in July 1998 that, if the Armouries did not support the Dock development, there was a significant risk that RAI's financial position would deteriorate, possibly leading to insolvency. However, if the Armouries did support the redevelopment, it was likely that RAI would eventually become profitable, although, in the medium term, the construction work arising from the redevelopment was likely to have an adverse effect on the visitor numbers.

1.64 Schroders considered that RAI would eventually become profitable for two reasons. Firstly, RAI would use its share of the proceeds arising from the Dock development to pay off some of its debts and so reduce its borrowing costs. Secondly, the completed development would boost visitor numbers through increased passing trade. However the Armouries disagreed with these two assumptions. As a result of external factors and increases in the costs of site preparation, the level of development proceeds, and therefore RAI's share, had been reduced. In the Armouries' view all of this reduced RAI share would have to be used by RAI to meet the increased losses arising from decreased visitor numbers during the development construction work. None would therefore be left to reduce RAI's borrowing costs. The Armouries also felt that the underlying assumptions about visitor numbers used by Schroders were too optimistic.

1.65 Thus, by the end of 1998 the Armouries considered that the development gain was unlikely to be at a level to solve RAI's financial problems and that RAI would continue to make losses. Also, RAI's total loans had further increased to £15.8 million. RAI had expressed to the Armouries and Department in October 1998 its willingness to work on joint proposals with a view to ensuring the museum's long-term viability. The Armouries therefore met with the Department in November 1998 to discuss how it should work with RAI to solve these problems. The Armouries decided to seek an increase in its own grant-in-aid funding in order to meet the new museum's deficit and to persuade RAI's bank to continue to support the project.

The Armouries could not respond quickly

1.66 Although the Armouries recognised that the Bank of Scotland's position was critical to the outcome of the joint venture and that there was a need for discussions with the Bank about the financial difficulties facing the museum, there was no formal direct communication between the Armouries and the Bank until a meeting between the two in May 1999. The Bank then insisted that RAI should attend any subsequent meetings, if held, as the Bank's contractual relationship was with RAI and not the Armouries itself. RAI's attendance at these subsequent meetings would have meant that discussion of any option which did not involve a continuing role for RAI in the museum would have been difficult. The Armouries, however, could not insist on meeting the Bank without RAI as the Armouries had no contractual relationship with the Bank under the terms of the 1993 deal.

1.67 The Armouries had the right, under the project agreement, to terminate its agreement with RAI in the event of its financial failure. However the Armouries could not exercise this right for a period of two years after the appointment of a Receiver or Administrator nor at any time after this whilst the Receiver or Administrator continued to substantially perform RAI's obligations under the PFI contract and its sub-lease of the museum. In addition, although the Armouries could take ownership of the museum in certain circumstances, under the terms of RAI's sub-lease the Armouries could not exercise this right while a Receiver or Administrator was in place if it sought to take possession because of RAI's financial failure itself. The Department received advice from the Armouries' legal advisers, Irwin Mitchell, in 1999 that, because of these provisions, during this moratorium period the Armouries would not be able to operate the museum itself without the consent of RAI and any insolvency practitioners concerned. In the event of RAI's receivership therefore the museum's operations would become subject to severe disruption, substantial uncertainty for possibly at least a year, and in all likelihood a severe falling off in standards. To avoid this, the Armouries would have to reach a deal with RAI's creditors, in this instance the Bank of Scotland.

1.68 The legal advice also warned of the possibility of the museum's closure in the event of RAI's receivership. The Receiver's objective would be to reduce the financial exposure of the creditors. The Receiver would therefore only continue to keep the museum open if there was a realistic prospect of paying the museum's overheads on a going concern basis, or of selling the business. Given the museum's poor financial performance, neither of these was likely. It was therefore possible that the museum would be closed by the Receiver for an extended period, despite a restrictive covenant in RAI's sub-lease of the museum that the museum be kept open at all reasonable times, and that the Armouries would be unable to gain access to keep it open because of the moratorium period.

1.69 The moratorium period only applied if the Armouries sought to terminate the PFI contract and gain access to the building because of RAI's insolvency. The Armouries could have terminated the contract if RAI were in fundamental breach of this, and taken possession of the museum almost immediately if the PFI contract had been terminated or RAI were in material breach of the sub-lease. In our opinion any closure of the museum by the Receiver would be likely to have been a significant breach of both the PFI contract and the covenant in RAI's sub-lease that the museum be kept open at all reasonable times. The Armouries could therefore reasonably expect to be able to terminate the PFI contract and take over the museum, subject to giving the Receiver notice of this, allowing a reasonable period for the correction of the breach, and then, if necessary, obtaining an appropriate court order. In Irwin Mitchell's view, the obtaining of such an order would have taken up to at least three months and possibly longer. In our opinion these provisions meant that, if the Receiver were to have closed the museum, the period of closure would not necessarily have been indefinite or for a period which was unacceptably long as it would have been a significant breach of the contract. RAI's receivership would still, of course, have entailed disruption and uncertainty.

There was concern over additional liabilities if RAI went into receivership

1.70 The Armouries considered that it would probably have incurred extra costs if RAI had gone into receivership, for which it did not have the additional grant-in-aid required. For example, as explained above, if RAI had gone into receivership, because of the provisions in the 1993 contract documents the Armouries would have had to reach a deal with the Receiver, on behalf of the Bank of Scotland, if it wanted to take over the museum without much delay and so avoid the disruption and uncertainty that RAI's receivership would entail. In agreeing such a deal, the Receiver, on the Bank's behalf, would have sought to ensure that any payment it received from the Armouries in return for waving its rights over the museum would have been sufficient to cover in full the Bank's outstanding loans with RAI. This payment would have taken the form of either an up-front lump sum payment by the Armouries or the payment of rent by the Armouries to the Bank for the use of the museum.

1.71 However the actual level of payment by the Armouries would have been the subject of negotiation between the Receiver, on behalf of the Bank, and the Armouries. Under the terms of RAI's sub-lease the building could only be used as a museum. As the Armouries' own legal advice noted, given RAI's heavy losses in running the museum, it was unlikely that there would have been much third party interest in buying the building and the only likely purchaser would have been the Armouries itself. In our opinion the Armouries would have been in a good negotiating position because of this restrictive covenant on the building's use, and it would not have been certain that the Receiver would have succeeded in negotiating a payment from the Armouries which covered in full the Bank's outstanding loans with RAI. For example, the Armouries told the Bank in May 1999 that the maximum that it was likely to be able to afford to pay would not be sufficient to pay off RAI's outstanding bank debt. For its part, the Department's view, based on Irwin Mitchell's advice, was that the payment required by the Receiver, on the Bank's behalf, could have been substantial as the provisions for a moratorium period of at least two years would have given the Receiver a strong hand in negotiating the terms and the level of this payment.

1.72 In addition to the payments to the Bank of Scotland, the Armouries would have incurred other expenses if RAI had gone into receivership. Under RAI's sub-lease of the site RAI reimbursed the Armouries for the annual rent that the Armouries itself paid to the British Waterways Board (paragraph 1.16). However, if RAI were to go into receivership and cease to reimburse the Armouries, the Armouries would have had to meet the costs of the rent due to the British Waterways Board itself. These extra rental costs would have amounted to £3.4 million in net present cost terms over a 25 year period. However, we note that, if RAI or the Receiver had ceased to pay the rent due to the Armouries, this would have been a breach of RAI's sub-lease of the museum.

The Department's objective was to keep the museum open at the lowest additional grant-in-aid

Closure or partial closure of the museum had the lowest estimated cost

1.73 In light of the Armouries' analysis at the end of 1998 (paragraph 1.65) and its own review of RAI's published accounts early in 1999, both of which identified that RAI was likely to make continuing losses even with the Clarence Dock development and that therefore RAI was unlikely to continue trading in the medium term, the Department in March 1999 formalised the scope of a joint review by the Armouries and RAI of the options for the museum's future, for completion by June 1999.

1.74 The Armouries and RAI agreed that their common objective was to secure the museum's long term future. However they could not reach an agreed solution for achieving this and, as a result, the appraisal that was produced in July 1999 was not an agreed document. The options considered are summarised in **Figure 11**.

1.75 The appraisal showed that the alternative of persisting with the current situation, with RAI continuing with its existing responsibilities and the Armouries funding RAI's losses from its own grant-in-aid, was the most expensive option. In contrast, those options involving RAI's receivership and the closure of the museum, in full or in part, (Options 2, 3 and 4) had the lowest cost for the Department and the Armouries.

Closure of the museum or the expansion of RAI's role were considered unacceptable

1.76 The Department clearly stated, in June 1999, that its objective was to deliver a solution which kept the museum open while minimising the requirement for additional grant. It considered that, although closure of the museum would not breach the Royal Armouries' statutory duties, which could be fulfilled through continuing to maintain displays at the Tower and Fort Nelson, closure would have had major disadvantages for the Armouries.

1.77 Firstly, as the great majority of the collection was housed in Leeds, any option which involved the loss of the building would necessitate paying for alternative premises. The Department considered that, as there were no provisions in the agreement for the museum to return to the Armouries immediately if RAI went into receivership (paragraph 1.67), the building would be lost to it. Consequently it might have to fund the cost of a new building to store the collection, estimated at £9.5 million.

1.78 Secondly, the Department considered that, because the terms of the agreement did not allow the Armouries to terminate the contract with RAI for at least two years while a Receiver was in place (paragraph 1.67), the Armouries would have had great difficulty in taking direct control of the museum's operations in order to ensure its continued opening and the avoidance of disruption and uncertainty. Allowing RAI's insolvency was therefore a highly risky strategy.

1.79 Finally, if the museum closed after RAI went into receivership, this would lead to some savings in the Armouries' staff costs. However the Armouries would still face significant costs, including redundancies among its staff who worked in the museum (paragraph 1.30), a payment to the Bank to gain the right to have immediate access to the museum (paragraphs 1.70 to 1.71), and the annual rental payments to the British Waterways Board (paragraph 1.72). The Armouries did not have the funding available in its grant allocation to meet these costs.

11 Royal Armouries' financial appraisal of options

The Royal Armouries' analysis showed that the options which involved the closure of the museum were cheaper than its preferred option under which it would take over entirely responsibility for the museum.

Option	Cost £ million[1]	Expected outcome	Comments
(1) RAI continue with current responsibilities; the Armouries funds its operating losses	91.4	RAI remain solvent and the museum remains open	The Armouries would bear the increased costs, including annual operating losses of £2.5 million and maintenance costs, from increased grant-in-aid.
(2) Do nothing and the museum moves elsewhere	53.0	RAI goes into receivership, the museum closes, and the collection moves to a new building	There would be some savings in staff costs but these would be offset by costs to the Armouries, including lease payments, redundancy costs and the funding of a new building to store the collection. The collection would not be on display.
(3) Do nothing and the museum closes temporarily	44.5	RAI goes into receivership and the museum closes temporarily	The financial implications are similar to Option 2, but this option assumes that the Armouries reach a settlement with RAI's lenders which allows the collection to continue to be housed in the Leeds museum.
(4) The Royal Armouries funds the limited opening of the museum	59.1	RAI goes into receivership and the museum remains open on a limited basis	Additional grant would be required to fund the museum's limited opening at weekends and school holidays, and to meet lease payments and redundancy costs.
(5) RAI takes over the management and operation of the Royal Armouries, including its role in operating the Leeds museum, and provides support services for the Armouries' other museums at the Tower and Fort Nelson	76.0	RAI remains solvent and the museum stays open	The Armouries would outsource its support functions to RAI for a fee. RAI would manage the museum, take on all operating costs and staff costs. RAI would then sublet areas of the museum to the Armouries to carry out its statutory duties. This option assumed that RAI's lenders would provide long-term support and re-structure existing debt. RAI would retain operating risk, and responsibility for the existing debt.
(6) The Royal Armouries takes over operation of the museum, including all RAI's former operational responsibilities	60.2	RAI becomes a shell company and the museum stays open	RAI's management is made redundant and a single management structure within the Armouries is established. RAI staff transfer to the Armouries. RAI grant the Armouries an operating contract, in return for the payment of rent. Savings from the integration of the two bodies are offset by additional costs to the Armouries including rental payments, maintenance costs and operating losses. The Armouries would retain its share of the development gain.
(7) RAI's preferred option	79.6	RAI remains solvent and the museum stays open	RAI continues with "commercial" operations - ie corporate entertainment, catering and car parking. The remaining core museum operations revert to the Armouries, who obtain control of the museum. This option would require an increase in grant from the Department to fund core museum operations. The Armouries forfeits its rights to a share in the development gain from the Clarence Dock development. RAI retain responsibility for the existing debt.

Note 1: The figures represent the total costs of each option discounted over 25 years.

Source: The Royal Armouries

1.80 In addition to the operational difficulties caused to the Armouries, the Department also considered closure to be unacceptable as this, in its opinion, would have involved the loss of a national museum in the north of England, which had been built with £28.5 million of public investment, and the first public failure of a PFI project. The closure would also have had a negative impact on the Clarence Dock development scheme and therefore the regeneration of the surrounding area. If the current scheme had collapsed because of the closure of the museum, the prospects of any future development of the Dock would have been greatly decreased for the next five to ten years.

1.81 For these reasons the Department ruled out further consideration of the cheapest options - 2, 3 and 4. The Department's policy was to avoid the museum's closure, if possible, and the Department and the Armouries considered that, under these options, the museum would probably close, either in part or in full at least for a short time, despite this being a breach of RAI's sub-lease (paragraphs 1.68 to 1.69).

1.82 The Department also rejected Option 5, which involved expanding RAI's responsibilities to generate more income, on the basis that RAI lacked the financial stability to take on further responsibilities. The option was also more expensive than Option 6, and it was felt that there would not be enough focus by RAI on the delivery of the statutory functions.

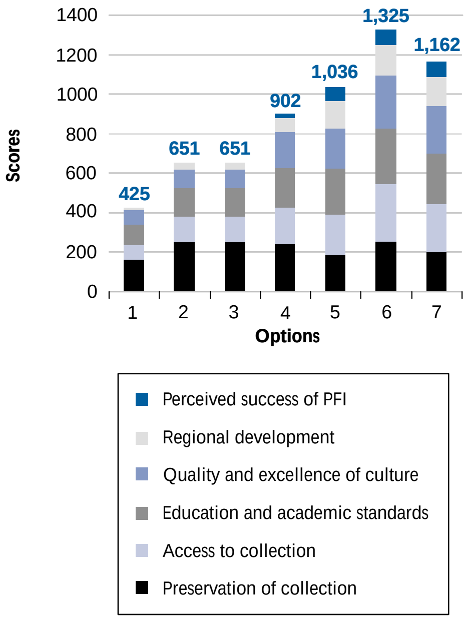
The Armouries preferred to take over responsibility for the museum itself

1.83 The Armouries preferred Option 6, even though this was not the cheapest. Under this option, the operation of the museum would be returned to the public sector. RAI would, however, stay in existence as a shell company, but with no operational role. The Armouries and RAI would continue to receive shares in the development gain.

1.84 Although Option 6 was not the cheapest alternative, both the Armouries and the Department considered that there were other principles in addition to financial considerations when managing a museum. The Armouries therefore, at the same time as its financial appraisal, also evaluated the options against non-financial criteria, in line with Treasury guidance on options appraisal. These criteria included compliance with the Armouries' own statutory duties as well as compliance with the Department's new objectives for the project - securing the regeneration benefits arising from the redevelopment of Clarence Dock and securing the reputation of the PFI. This analysis showed that Option 6 best met these non-financial criteria **(Figure 12)**. The museum would remain open and the positive impact of the museum on the local economy and the Clarence Dock development would continue.

12 Royal Armouries non-financial appraisal of options

The Royal Armouries considered that, based on non-financial factors, Option 6, its own take-over of the museum, was the best option.



Source: Royal Armouries

The Department recommended that the Armouries accept a late proposal from RAI

1.85 RAI proposed a further option to the Department in late June 1999 (Option 7) for which it had obtained the support of the Bank of Scotland. Under this option RAI remained in place, though with reduced staff numbers, and retained the profitable corporate entertainment and car parking activities, and catering. The Armouries would take over responsibility for the remaining core museum functions, which it would support with additional grant-in-aid from the Department. Provided this option was adopted, the Bank was prepared to continue supporting RAI with further working capital and any net profit from RAI's future operations would flow to the Bank to repay the outstanding debt. In addition, all the financial proceeds due to the Armouries and RAI under the 1993 agreement with the British Waterways Board would go to RAI, to offset its existing debt.

1.86 The Department had a number of reasons for recommending this option to the Armouries. Firstly, it considered that this was the only option which was certain to meet its objective of keeping the museum fully open as RAI had told it that this option had the full support of the Bank of Scotland, RAI's principal lender. The Department considered that, if it supported the alternative option of the Armouries taking over all RAI's operational responsibilities (Option 6), RAI would go into receivership, leading to the likely closure of the museum, with the loss of control and uncertainty of outcome that this would entail (paragraphs 1.67 to 1.69). Option 6 could not therefore be achieved without the agreement of RAI or the Bank, and RAI did not agree.

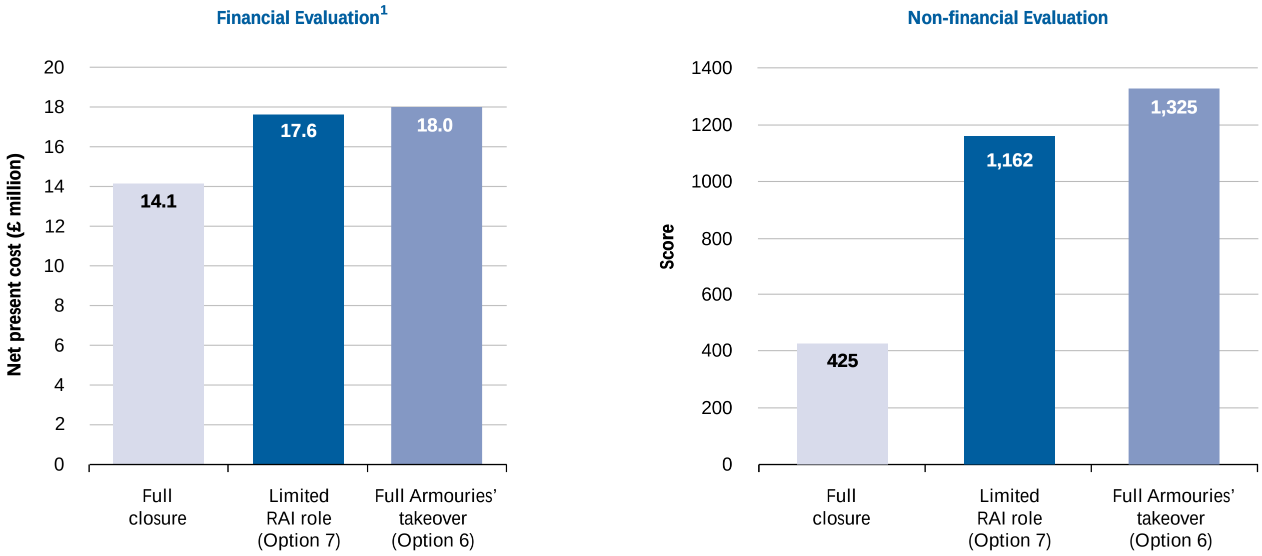
1.87 Secondly, the Department considered that the new option (Option 7) offered better value for money. It estimated that the option was marginally cheaper than the Armouries' preferred option, while offering a similar level of non-financial benefits **(Figure 13)**. Under the Armouries' calculations, Option 6 had been less expensive than Option 7 (Figure 12) as, although the Armouries had assumed that it would need to pay rent to RAI in order to get speedy access to the museum, it had not quantified this payment since the payment had yet to be negotiated. The Department therefore assumed in its calculations that, under the Armouries' preferred option, the public sector would be asked to pay as rent the annual cost of £900,000 of servicing the existing RAI debt in full. For its part the Armouries considered that the maximum rent that it could afford to pay was likely to be insufficient to pay off the outstanding debt.

1.88 Lastly, the Bank formally confirmed that, if RAI's proposals were accepted, then the Bank would have no recourse to the Department or the Armouries to support RAI other than as set out under RAI's proposals. The Armouries would therefore not become responsible for RAI's outstanding debt of £20 million. The Department considered that the retention of this large liability in the private sector was in accordance with PFI principles and was a significant achievement.

1.89 The Department therefore formally recommended RAI's proposals to the Armouries in July 1999. It told the Armouries that this was the only option for which it would provide additional grant-in-aid.

13 The Department's appraisal of options

The Department considered that the option which involved a limited role for RAI (Option 7) offered the best value for money.



Note 1: The net present costs are based on the marginal costs of each option, discounted over 25 years. Option 6 includes payments to the Bank of Scotland in respect of outstanding debt.

Source: Department for Culture, Media and Sport

The revised deal transfers risk back to the Armouries, although it also does result in some benefits

The Armouries is now responsible for the loss-making parts of the museum operations

1.90 The Armouries and RAI reached an agreement on 30 July 1999 which restructured their relationship and provided a framework for completing the Clarence Dock development. Under the agreement, the Armouries has taken on responsibility for the core museum functions from RAI, and will fund these functions from museum revenues and additional grant from the Department (**Figure 14**). There have also been revisions to the contractual structure (**Figure 15**). As a result the Armouries now has sole control of the discharge of its statutory duties.

1.91 As the Armouries now is responsible for meeting all the museum's costs from any revenue it generates, a significant element of the demand risk associated with visitor numbers has been transferred to the public sector. Before taking on this risk the Armouries commissioned KPMG to review the museum's future potential operating performance, including future trends in visitor numbers. KPMG reported in June 1999 that the development of Clarence Dock, when complete, would attract people to the surrounding area, increasing the likelihood of admissions to the museum rising due to passing trade but that the resulting increase in visitor numbers would be at most ten per cent. However, if the Armouries took certain other steps, visitor numbers could be increased to at most 300,000 a year.

1.92 Subsequently the Armouries and the Department have identified further measures which could help to increase visitor numbers further. The Department, as part of its access policy for the charging museums that it sponsors, has agreed to make further resources available to the Armouries to provide free access for children and the over-60's from April 2001 and to enable the museum to introduce a reduced charge of £1 for adults from September 2001.

1.93 For its part RAI has retained responsibility for the provision of corporate entertainment and catering for 40 years, and for car parking for 57 years. The revised agreement contains no details of the level of charges RAI will levy on visitors for these services, although it does require these charges to be approved annually by the Armouries. RAI will also operate, and retain the income from, a new exhibition hall, being constructed as part of the Clarence Dock redevelopment, for 57 years or until its bank debt is fully repaid, whichever is the earlier.

14 Responsibilities of the parties from 1999

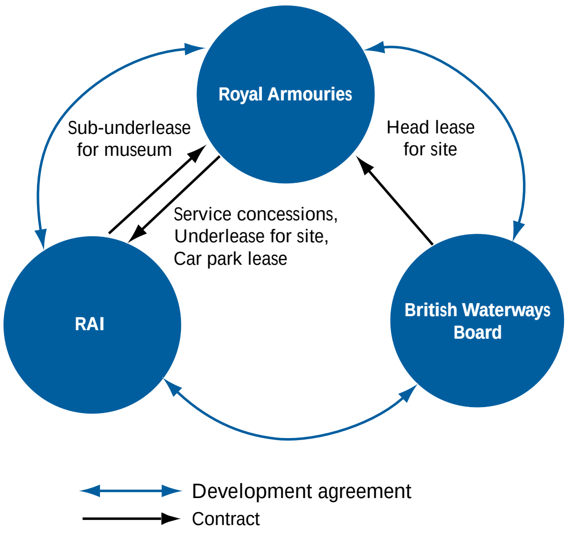
The Royal Armouries took on virtually all responsibility for the new museum from July 1999.

Public Sector Responsibilities	Private Sector Responsibilities	Joint Responsibilities
Operational phase		
Continue to lease the site for the new museum for 999 years[1] from existing owner, the British Waterways Board, and sub-let to the private sector for 60 years. Pay the agreed lease rental to the British Waterways Board	Under the sub-lease, reimburse the Royal Armouries for the annual rent payable to the British Waterways Board	Draw up an agreed operating specification for the services RAI is to provide
Pay the rent due to RAI under the sub-sub-lease for the museum	Sub-sub-let the museum to the Royal Armouries for 58 years on a full repair and insure lease, for the rent payable under RAI's own sub-lease with the Armouries	
Provide the major part of the collection for exhibition in the new museum and acquire new items for the collection	Provide car parking, catering and corporate hospitality and retain the income from these	
Fund the museum's operating costs from the receipts from visitor income and other income sources, such as retail and sponsorship income, and manage the marketing and promotion of the museum		
Provide, and pay for, all Royal Armouries' staff to care for and maintain the collection, and to deliver interpretative, education and research services		
Maintain the building and fixtures and fittings		
Development of Clarence Dock		
	Retain its own and the Armouries' share of the net profit from the development	

Note 1: Once the development agreement becomes active, the Armouries' 999 year lease on part of the site lapses, although the Armouries has the right to resume the lease of this land after the development period.

Source: 1999's revised contract documents

15 Contract structure from 1999



Source: National Audit Office

1.94 It will use the income from these activities, and its share of the gain from the development of Clarence Dock, to repay its bank debts of almost £21 million for which it has retained responsibility. It is possible that, once these debts are repaid and its business sufficiently successful, RAI's investors might receive some return on their investment.

1.95 The revised agreement set out the general levels of performance expected from RAI for the catering, car parking and corporate hospitality services. The detailed requirements were set out in new operating specifications which were substantially agreed by the Armouries and RAI in September 2000, over a year after the signing of the revised agreement, and which are currently in the process of being signed off. Under the revised agreement the Armouries does have the right to terminate RAI's provision of these services if RAI is in fundamental breach of the revised agreement. However the revised agreement still does not define the level of poor performance by RAI which would constitute such a breach. The Armouries, however, told us that in practice it could approach the Bank of Scotland if it felt that RAI was not taking action to improve its level of service. It would also have to warn the Bank if it proposed to take any action in the case of fundamental breach by RAI (paragraph 1.69).

The Armouries is having to meet other, additional costs

1.96 Under the July 1999 agreement the Armouries transferred its share of the future proceeds from the Clarence Dock development to RAI, to be used in paying back RAI's debt. The master agreement for the site's development was signed with Berkeley in March 2000. Under this RAI will eventually receive £3.8 million as its share of the total development gain.

1.97 The Armouries has sub-let the museum buildings from RAI on a full repair and insure basis. Under this new sub-lease the Armouries is now responsible for the rental payment due to the British Waterways Board. The buildings will revert to the Armouries once RAI's bank debt (set under the revised agreement at almost £21 million) is repaid in full or when the lease expires in 2057. Should RAI go into receivership before this, the Armouries' position is protected as it will be occupying the museum under the terms of its own sub-lease.

1.98 Following the signing of the revised agreement, there was a period during which the Armouries took over financial responsibility for the museum operation, while RAI still managed the operation of the museum. The Armouries took over financial responsibility in this period as RAI had no banking facilities available to it to fund the payment of its liabilities. The handover period was also needed to allow the finalisation of various detailed matters. The period ended in January 2000 when the Armouries took over full operational responsibility.

1.99 As part of the revised agreement the Armouries had agreed to contribute to the cost of work carried out on its behalf by RAI during this handover period. The total contribution from the Armouries amounted to £203,000, mainly in respect of liabilities incurred by RAI prior to the revised agreement but from which the Armouries received benefit during the handover period. This figure could increase as there is a possible claim for a sum retained by RAI on the original construction contract. The Armouries told us that it considers that it is not liable for this claim under the terms of the revised 1999 agreement. RAI disagree. The Armouries has also had to pay consultants and legal fees of £28,000 and extra staff costs of £20,000 because of the handover. The Armouries also incurred costs associated with the transfer of about 90 RAI staff, estimated at £1.3 million a year.

The Armouries is having to make efficiency savings

1.100 The Department made it clear to the Armouries, prior to the signing of the revised agreement, that cost savings would be required in the wake of the agreement in return for extra grant-in-aid to enable the Armouries to meet its new responsibilities. However it also said that it would make substantial further grant-in-aid available in support of the new agreement.

1.101 In September 1999, after considering the Armouries' revised expenditure plans, the Department agreed to increase the Armouries' grant-in-aid by £1 million a year from and including 1999-2000. However the Armouries estimated that this would still leave them with an annual funding gap of £1.8 million in respect of its new responsibilities. In order therefore to meet its new responsibilities while containing expenditure within the increased grant levels, the Armouries made cost savings of £1.3 million in 1999-2000, with a full year effect in 2000-01 of £1.9 million. These savings were made across the whole range of the museum's activities.

1.102 In the Armouries' view these savings have been partly achieved by increased efficiency, resulting in savings that are sustainable in the long term. These efficiency savings include reductions in manpower and the redirection of resources to the core museum product and customer services. The Armouries also attributes other of the cost savings to the fact that it has been able to absorb the management and central services workload transferred from RAI with minimal increases in its own staff and costs. In addition, it told us, other economies involved the deletion of some projects and enhancements across all areas of activity including reductions in capital investment and maintenance, and the costs of exhibitions, acquisitions and marketing.

1.103 The immediate impact on the museum's service has been limited. The need to reach a revised agreement and then make these cost savings took priority. Consequently the Armouries has failed to achieve in 1999-2000 some of its lower priority performance targets. However the Armouries has found that the cost of running the museum has been less than it expected in 1999. In the short term the Armouries aims to lay a sound platform for the future by arresting the decline in visitor numbers and achieving stability in the early years. In the longer term its objectives are to build on this success and reverse the previous decline through continued improvements and enhancements to the museum product and visitor services (paragraphs 1.91 to 1.92).

1.104 In November 1999 the Department and the Armouries commissioned, at a cost of £67,000, a detailed assessment by PricewaterhouseCoopers of the longer-term sustainability of the museum with the additional grant of £1 million per annum. The study concluded in January 2000 that the museum would be sustainable at this level of additional funding, providing that there were radical changes in the management structure in order to increase commercial awareness in the Armouries, the implementation of a number of economies, and changes in the presentation of the collection and the marketing of the museum.

1.105 In line with these recommendations the Armouries has appointed a new Chief Operations Officer in October 2000 to work with the Master of the Armouries to develop the Armouries' strategy, to oversee the operation of all departments, and to take responsibility for the day-to-day running of the museum. The Armouries has also established a new marketing section, with a new Director of Marketing in place from July 2000, and new appointments have been made to the Board of Trustees, including a marketing specialist.

1.106 The Armouries has also commissioned a fundamental strategic review in 2000 by an independent consultant. It will aim to establish what needs to be done by way of new management structures, improvements in marketing and other strategies to ensure that the level of funding available is sufficient in the medium term to allow the Armouries to respond adequately to the Government objectives for national museums at the same time as meeting its statutory duties. The results of this review will be amalgamated in the museum's strategic plan which is due to be completed by the end of 2000.

The revised deal does benefit the Armouries

1.107 The revised deal has meant that the Armouries has received a number of benefits. The museum has not closed and a smooth transition to the new operating regime has been achieved. The Armouries has also taken control of a fully trained operational workforce in order to run the new museum, on private sector terms and conditions. The Armouries will also receive 20 per cent of RAI's turnover from its corporate entertainment and catering activities as a royalty once RAI has paid off its debt. After 40 years the Armouries will also receive from RAI 20 per cent of the car parking income and all of this after 57 years. The Armouries will also eventually have sole use of the new museum (paragraph 1.97), the construction of which has been funded with the help of the private sector.

1.108 The revised deal has also ensured the survival of the Clarence Dock redevelopment. Outline planning permission for the development was granted in February 2000 and the start on site is planned for summer 2001. Although under the revised deal the Armouries' share of the proceeds from this development will now go to RAI, the Armouries will still benefit from this development in a number of ways (**Figure 16**).

The revised deal secures benefits for the community

1.109 According to the Leeds Development Agency the existence of the museum brings a number of benefits for the local economy and community (**Figure 17**). As the revised deal ensured that the museum would stay open, it also ensured that the local community continues to receive these benefits.

1.110 The revised deal also ensured the survival of the scheme for the redevelopment of Clarence Dock. According to Leeds Metropolitan University's Centre for Urban Development and Environmental Management this scheme will result in a number of benefits for the local economy and community (**Figure 18**).

16 **The benefits to the Royal Armouries arising from the Clarence Dock development**

The Royal Armouries benefits from the Clarence Dock development in a number of ways.

- Additional car parking for visitors to the Armouries
- 15,000 square feet of further storage space for the collection at a peppercorn rent
- 12,500 square feet of further expansion space
- The use of, and all income from, a new exhibition hall from the end of RAI's lease in 2057 or earlier if RAI manages to pay off its debts before this date
- A potential increase in passing trade as people are attracted to the area by the redeveloped docks

Source: National Audit Office

17 **The benefits to the Leeds economy and community arising from the museum**

Leeds benefits from the presence of the museum in a number of ways.

- The museum employs around 200 staff who contribute £7 million to the local economy
- Tourism generated by the museum contributes around £11 million to the community and supports about 380 jobs
- Corporate entertainment at the museum introduces many national and international businesses to Leeds, acting as a flagship for inward investment
- Around 160 local school groups each year enjoy free admissions to the museum
- The museum is part of the regional museum and visitor attractions network

Source: Leeds Development Agency (1999)

18 **The benefits to the Leeds economy and community arising from the Clarence Dock development**

By acting as an "anchor tenant" the museum underpins the Clarence Dock development, which will benefit the local economy and community.

- 2,410 jobs will be directly created in the Clarence Dock area
- The wages from these people will be passed into the local economy
- The one million square feet of development will provide £100 million of inward investment
- The development will deliver significant planning gain under the terms of the planning approval and will underpin the viability of the proposed supertram light rail transport system
- The local council will benefit from higher council tax and commercial rates receipts

Source: Leeds Metropolitan University (1999)

Part 2

Developments in PFI have made a similar outcome on other PFI projects less likely

2.1 The deal with RAI in 1993 was one of the very first PFI deals signed. At the time there was no guidance available to the Armouries and the Department on how to structure such deals nor was there much experience within government and in the private sector. This Part therefore examines whether current guidance on good practice on PFI deals would have strengthened the Armouries' and the Department's position in coping with RAI's financial problems and the threat which these posed to the museum's continued operation.

2.2 Since the signing of this deal in December 1993 the PFI has developed greatly. Many more such contracts have been signed and there is a large body of guidance now available to public bodies who want to enter into such deals.[3] Consequently this Part shows that developments in the PFI have made a similar outcome on other PFI projects less likely and that compliance with guidance now available appears to us likely to have enabled the Armouries to tackle more easily the problems on this project and at an earlier stage. In our opinion this earlier intervention may have opened up more opportunities for saving the deal as options which were not considered to have been feasible in 1999 may have been in 1997.

It is unlikely that a similar project would be approved without a clearer demonstration of value for money

2.3 Current guidance states that PFI solutions should be pursued where they are likely to deliver better value for money, and that healthy competition is often the best guarantor of value for money.[4] On this project there was little interest in the project in the market place. The Armouries, the Department and its advisors were unable to obtain any competing bids for the original agreement with RAI (paragraph 1.23). They nevertheless decided to proceed with the project, rather than consider whether the project should be cancelled or re-scoped to try and attract more private sector interest.

2.4 In addition to effective competition, the guidance recommends that, in most cases, value for money will also need to be demonstrated by comparison of private sector PFI bids with a detailed public sector comparator.[5] On this project, although there was some consideration of alternative ways of involving private finance in the new museum in 1991 and 1992 (paragraph 1.22), no public sector comparator, which assumed the provision and operation of the new museum using entirely public funding, was prepared for the project prior to contract signature in 1993. This was because the Department had decided in June 1991 that the new museum should not be totally funded by the public sector but some of the funding should come from the private sector (paragraph 1.14). Also, this was an early PFI scheme and guidance on the preparation of public sector comparators had not been developed.

RAI would have had more freedom to deal with the financial crisis

2.5 One of the objectives set for the original deal was to achieve maximum risk transfer to the private sector. This was in line with practice on PFI deals at the time. The 1993 deal transferred all operating and demand risk to RAI by making RAI responsible for the costs of operating and maintaining the museum, which were funded solely through museum revenues and any future share in development gain (paragraphs 1.27 to 1.28). However current guidance on the allocation of risk in PFI deals is that risk should be allocated to whomever from the private or public sector is able to manage it at least cost. The public sector body should therefore seek the optimum, not the maximum, transfer of risk.

3 *Responsibility for the production of this guidance transferred from the Treasury's Private Finance Taskforce to the Office of Government Commerce in April 2000.*

4 *Treasury Taskforce "Partnerships for Prosperity" (November 1997) paragraphs 3.08 and 3.10*

5 *Treasury Taskforce "Partnerships for Prosperity" (November 1997) paragraphs 3.10 to 3.12 and Treasury Taskforce Policy Statement No. 2 "Public Sector Comparators and Value for Money" (February 1998) paragraph 2.3.2*

2.6 The guidance now available does, however, support the transfer of demand risk to the private sector where services are not being provided directly to the public sector. It states that, where the public sector is not the only user of the services provided (as in the Armouries' case), consideration must be given to the possibility of transferring demand risk.[6] In these cases, for example, roads and other transport links, the public sector cannot directly control usage levels. On this project demand risk was high as the museum was a new attraction with no proven "footfall" (paragraph 1.28).

2.7 Current guidance recognises that, where risk is transferred to the private sector, including demand risk, the private sector party should have clear ownership, responsibility and control of the risk. However, on the Armouries project, the private sector did not have clear ownership, responsibility and control of demand risk because of the division of operational responsibilities for the museum. Under the original agreement there were a number of aspects of the operation of the museum that were shared between the Armouries and RAI. For example, promotion and marketing of the museum, an activity which would have a significant effect on demand, was a shared responsibility under the original agreement (Figure 6). There also needed to be close co-operation between the Armouries and RAI on the generation of income (Figure 10). The Armouries points out that responsibility in these areas was shared as the deal was more of a partnership between itself and RAI than a conventional PFI project.

The Armouries would have been able to intervene earlier

An agreed performance regime would have enabled the Armouries to tackle RAI's performance more effectively at an earlier date

2.8 Failure to draw up the operational specification is poor practice according to current PFI guidance. This recommends that the output specification, including the levels of performance required of the private sector party, be agreed before the contract is signed and form part of the contractual documentation.[7] The failure to draw up an operating specification required under the original agreement meant that the relationship of the Armouries and RAI in key matters was not defined. This in turn made the early resolution of the disputes that arose, for example, about income generation difficult as there was no agreed standards or requirements with which RAI's measures to increase its income had to comply (paragraphs 1.48 and 1.56). The scope for such disagreement would have been reduced if there had been an operating specification which set down the pre-agreed requirements in each disputed area and if RAI's financial predicament had not been so great because of the reduced numbers of visitors.

2.9 The existence of an agreed operating specification would have complemented the operating committee, which was in place on this project, as a way of enabling the Armouries to raise, on an objective basis, the issue of non-maintenance of the new museum as this document would have detailed the agreed performance levels which RAI was to meet for maintenance (paragraphs 1.50 and 1.56). The failure to agree the specification made it impossible for the Armouries to demonstrate its claim, which RAI refuted, that RAI's level of maintenance of the new museum was contractually unacceptable and therefore required resolution. However, given RAI's financial situation once the museum opened, it was highly unlikely that RAI would subsequently agree to such a specification, despite the Armouries' efforts (paragraph 1.29).

2.10 Guidance also recommends that the contract contain details of how the private sector party's performance should be monitored and the criteria against which its performance will be assessed.[8] On this project a detailed performance regime was not agreed (paragraphs 1.57 to 1.58). The existence of such a performance regime would have reduced the scope for disagreement over RAI's alleged non-performance of maintenance as the facts of the level of RAI's actual performance against the expected standards would have been clear.

Current contract terms would have allowed the Armouries to establish the extent of RAI's financial problems at an earlier stage

2.11 Prior agreement of the public sector client would now be needed before a refinancing. Guidance recommends that the private sector party's ability to refinance be limited in the PFI contract if such a refinancing materially and adversely affects the ability of the contractor to meet its contractual obligations.[9] In this case the Armouries had no right of prior approval of the refinancing but only learned of it subsequently (paragraph 1.61). The existence of such a right here would have strengthened the Armouries' position when asking for full details of RAI's financial situation since the Armouries could have insisted on the provision of such information as a condition of its agreeing to the refinancing.

6 Treasury Taskforce "Partnerships for Prosperity" (November 1997) paragraph 3.27
7 Standardisation of PFI Contracts 7.1.4, 8.1.2, and 9.1.2
8 Standardisation of PFI Contracts paragraph 9.3.1
9 Standardisation of PFI Contracts paragraph 14.6.8

2.12 PFI guidance now recommends that the public sector body should have extensive access to the private sector party's underlying financial records, as well as the published annual accounts.[10] On this deal the Armouries' rights of access were limited (paragraph 1.61). Such access would have enabled the Armouries to establish earlier the exact extent of RAI's financial difficulties. The Armouries has negotiated improved access rights to RAI's financial information under the revised 1999 agreement.

The absence of a direct agreement between the Armouries and RAI's lenders made it more difficult to reach a solution

2.13 It is usual on other PFI deals to have a direct agreement between the private sector party's lenders and the public sector client procuring the service. A direct agreement is the term given to an agreement between the public sector body letting the PFI contract and the senior lender to the project which is put in place when the original PFI agreement is signed. It deals with their relationship following the early termination or threatened early termination of the contract for a number of reasons, including default by the private sector party.

2.14 PFI guidance makes it clear that in certain circumstances direct agreements can benefit the senior lender in the event of possible termination of the contract. These circumstances include projects where the lender has no right to sell the project assets, and therefore security for their financing is limited to rights against sub-contractors and amounts in the bank accounts of contractors. Exercise of these rights by the banks is consequently unlikely to lead to full repayment of the outstanding debt. The National Audit Office considers that, on this deal, the bank's rights over the museum were not as strong as was thought because of the restrictive covenants in RAI's sub-lease. The Department disagrees with this assessment. The Department's view, based on advice from the Armouries' legal advisers, was that the payment required by the Receiver, on the Bank's behalf, could have been substantial as the provisions for a moratorium period of at least two years would have given the Receiver a strong hand in negotiating the terms and the level of this payment (paragraphs 1.67 to 1.71).

2.15 Guidance also considers that direct agreements can be advantageous to the public sector as they give senior lenders an opportunity to "step in", if they so choose, to save a project in difficulty before a contract is terminated, and so avoid the need for direct involvement by a department, and the disruption to the service following a termination. During the step-in the lender is given the opportunity to rectify performance failures or breaches of the contract.

2.16 In the case of the Armouries, there was no direct agreement providing the senior lender with step-in rights following a termination or threatened termination of the contract. The existence of such an agreement is no guarantee that a bank will choose to step in. Similarly, if RAI's bankers had truly wanted to step in to save this deal, they could still have asked the Armouries whether they could step in to attempt to save the museum even without such an agreement.

2.17 However the existence of a direct agreement on this deal would have benefited the Armouries. It would have created a direct relationship between the Bank of Scotland, RAI's lenders, and the Armouries and thus have strengthened the Armouries' position when asking for meetings with the Bank to discuss RAI's financial problems without RAI being present (paragraph 1.66). Under a direct agreement the private sector partner's banks would also have to tell the public sector body if the partner was having difficulties meeting its loans. The Armouries would therefore have got to know immediately of RAI's difficulties in meeting its debts.

The Armouries' position would have been stronger when faced with the termination of the contract

The Armouries' rights to terminate the contract would have been stronger

2.18 PFI guidance recommends that the contract should deal comprehensively with the consequences of early termination. It recommends stronger rights to terminate for liquidation than are contained in the 1993 Armouries deal (paragraph 1.67). The public sector body should simply have the right to terminate the contract for the private sector party's insolvency and there is no mention of any specific period of grace, as on the Armouries deal, other than the usual periods during which the client agrees to hold off terminating while the private sector party rectifies the default or the banks step in.[11]

2.19 Guidance also recommends that the contract spell out the level of poor service provision at which the public sector body can terminate the contract for the private sector party's default.[12] The existence of such a clause on this deal would have strengthened the Armouries' position when discussing RAI's alleged poor maintenance performance, compared to the actual contract provision agreed which allowed termination only for fundamental breach of contract without defining what this constituted (paragraph 1.58).

10 Standardisation of PFI Contracts paragraph 29.7
11 Standardisation of PFI Contracts paragraph 20.2.1.1
12 Standardisation of PFI Contracts paragraph 20.2.1

The Armouries would have had stronger rights of ownership over the building

2.20 PFI guidance recommends that the contract should address what happens to the assets involved, when a contract terminates either prematurely or at expiry. Assets with no alternative use and still required by the public sector should revert back to the public sector at no cost. Guidance also states that, as security, the banks will usually insist on a right of assignment to themselves of all the private sector party's rights under the PFI contract. Such rights are to be transferred under the direct agreement to the public sector in the event of contract termination in return for a compensation payment. The banks are also to release any security they have over the assets involved.[13]

2.21 The 1993 contract documents however did not allow for possession of the museum to revert immediately to the Armouries if it sought to terminate the contract with RAI for RAI's insolvency (paragraphs 1.67 to 1.69). It is possible that, if RAI had gone into receivership, a payment to the Bank would have enabled the Armouries to possess the museum relatively quickly, but the amount of the payment required by the Bank could have been substantial (paragraphs 1.70 to 1.71).

Provisions for the payment of compensation for contract termination for default by the private sector party may have resulted in the reaching of a revised deal more quickly

2.22 Current guidance recommends that any PFI contract should specify precisely what compensation is payable if the contract is terminated early. The guidance supports the payment of compensation to the private sector party where he is unable to perform his obligations, and the contract is terminated. It argues that this is justified where particular assets are developed to deliver particular services and the public sector is entitled to have the assets transferred to it on the contract's termination, since the transfer of these assets without the payment of compensation would unfairly benefit the public sector body. Such termination payments are also desirable as they give the banks assurance that they may receive back at least some of their lending on a failed PFI project. Without such an assurance the banks would charge higher interest rates for the financing that they provide.

2.23 The above provisions differ from Treasury's approach at the time of the deal. The Treasury had agreed in July 1992 to the contribution by the Department of £20 million to the costs of constructing the new museum on the basis that, should the private sector party default, ownership of the museum should pass to the public sector at no cost. The agreement for the new museum therefore made no provision for the payment of any compensation in the event of voluntary termination or default by the private sector partner. Given the uncertainty surrounding the ownership of the new museum in the event of the contract's early termination for RAI's receivership (paragraphs 1.67 to 1.69), the Armouries and the Department considered that, although not required by the contract, in practice there would have to be a payment to the Receiver or RAI's lenders in order to get ownership relatively quickly if RAI did go into receivership.

2.24 PFI contracts have contained a wide range of provisions for paying compensation to a private sector party when he defaults. Arrangements have varied from no compensation to full payout of senior debt. Current guidance recommends that the amount of compensation payable when the private sector party defaults should protect the public sector body's interests while not unreasonably penalising the private sector party for default. It should also encourage the senior lender to step in and rescue the project instead of relying on termination payments to pay the outstanding debt.

2.25 The guidance therefore recommends the payment of compensation based on the market value of the unexpired period of the contract.[14] Market value is established either by retendering for the remaining period of the contract, or, if there is no market for the contract, the public sector body pays an assessed value of the amount it would have received from a retender in compensation. The guidance states that, if the assessed value of the contract is negative, then the public sector body has a right to an equivalent amount of compensation from the private sector party, although the guidance states that the public sector body is unlikely to obtain any significant recovery.

2.26 In the case of the Armouries project, it is very unlikely that there would have been bidders for the unexpired period of the agreement, given the expected level of losses if the joint venture had continued in its current form, the lack of total control over income generation activities and the delays to the Clarence Dock redevelopment. This suggests that the contract would have had a low, or even negative, market value and so a low level of compensation would have been payable to RAI or its lenders if the contract had been terminated for RAI's insolvency. Therefore, under current guidance, it is likely that any compensation payable to the Bank if RAI had gone into receivership would have been insufficient to pay off all the debt that RAI owed it. This mirrors the effective consequences of the actual contractual provisions and the restrictive covenants contained in the contractual documentation on this deal (paragraphs 1.67 to 1.71).

13 Standardisation of PFI Contracts paragraphs 18.1.2, 19.2.1, 23.5, and 30.3.8

14 Standardisation of PFI Contracts paragraphs 20.2.5.1 and 30.3.8

If the Armouries had been able to intervene earlier, more options for restructuring the deal might have been feasible

The revised deal bears few hallmarks of a PFI project

2.27 As a consequence of the re-negotiations in 1999, the deal with RAI has been transformed from a PFI deal involving a joint venture arrangement with transfer of demand risk to the private sector to a publicly financed option, with the Armouries leasing the new museum from the private sector and having responsibility for its operation and maintenance. RAI retain responsibility for some support services.

Earlier intervention may have made more of the options for the resolution of the museum's problems more feasible

2.28 The Armouries cannot be criticised for any failure to follow guidance on best practice which only became available after the Armouries had signed this deal. The issue is whether the guidance, if it had been available at the time, would have resulted in a better outcome. In the National Audit Office's view, the incorporation of the elements of good practice listed above in the original 1993 contract would probably not have saved this deal in the face of a collapse in visitor numbers. However these elements might have allowed the Armouries to intervene more easily and at an earlier stage. This earlier intervention might then have opened up more opportunities for saving the deal as options which were not considered to have been feasible in 1999 may have been in 1997.

2.29 For example, in our opinion, it would have been easier for the Armouries to step in and operate the museum. In 1997 RAI's cumulative losses, and consequently the amount it owed to the Bank of Scotland, would not have been as extensive as in 1999. Therefore the amount that the Bank would have sought as compensation to allow the Armouries to take quick possession of the museum in the event of RAI's receivership would have been less. The Armouries and the Department wanted to avoid such extra payments to the Bank as they considered it good practice that the private sector retain responsibility for this debt (paragraphs 1.87 to 1.88). However Treasury guidance accepts the need for the payment of compensation in the event of the termination of the contract for the insolvency of the private sector partner (paragraph 2.22). The Armouries and the Department would also have had a better idea of the level of compensation they would have to pay as guidance recommends that the basis for such a payment be set down in the contract. In contrast, on this deal, there was uncertainty as to how much exactly would have to be paid (paragraphs 1.70 to 1.71).

Appendix 1 Chronology of events

Date	Event
1990	Production of "Strategy 2000"
1991	Selection of Clarence Dock, Leeds as the new museum's site. The Department require the funding of the new museum to be provided, in part, by the private sector
1992	
March	Approval for the establishment of a new museum in Leeds; appointment of Schroders as financial advisers
May	Schroders' report "Financing of Leeds project"
July	Treasury approval of contribution of £20 million to construction costs of new museum
1993	
March	Schroders' initial briefing memo issued to potential bidders
June	Withdrawal of Tussauds Group
December	Contract signed with RAI
1994	
January	Construction of new museum started
1996	
March	Museum opened on time and to budget
December	Gardner Merchant ceased to be the operator of the new museum
1997	
February	First re-financing
June	Berkeley Group selected as the developer for the redevelopment of Clarence Dock
December	National Audit Office identification of the need for a risk assessment
1998	
July	Schroders' risk report to the Armouries; second re-financing
1999	
July	The Armouries' options appraisal report; the signing of the revised agreement with RAI
2000	
January	PricewaterhouseCoopers "Royal Armouries Recovery Report" produced for the Department; completion of the handover of the museum from RAI to the Royal Armouries
February	Outline planning permission granted for the Clarence Dock redevelopment
March	Redevelopment agreement signed with Berkeley Group

Appendix 2 Scope and methodology of our examination

Scope of this study

1 We examined the original PFI deal signed by the Royal Armouries in 1993 and the subsequent events which led to financial problems for the Armouries' private sector partner, RAI, and the re-negotiation of the deal in 1999. We also considered whether current guidance on good practice on PFI deals would have strengthened the Armouries' and the Department's position in coping with RAI's financial problems, and whether there were any lessons which could be learned from this particular deal for future contracts.

Methodology

2 We undertook an issue analysis for this deal whereby we developed a number of detailed points for examination about high-level audit issues. In this case, the high-level audit issues were:

- Whether the establishment of the new museum was consistent with the Royal Armouries' long-term business strategy;
- How RAI's financial problems arose;
- Whether the terms of the original deal aided the resolution of this financial crisis;
- What options the Armouries and the Department considered to tackle the crisis;
- What the terms were of the revised deal made to save the museum; and
- Whether current guidance on PFI good practice would have helped the Armouries and the Department in coping with RAI's financial problems and the threat which these posed to the museum's continued operation.

3 We collected the evidence in support of our findings under each of these issues from examination of the information about the deal contained in the Department's and Royal Armouries' records. We also discussed the deal with the Department and Armouries, and the private sector partner, RAI.