

# The Sale of the Married Quarters Estate



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

*John Bourn*  
Comptroller and Auditor General

National Audit Office  
28 July 1997

The Comptroller and Auditor General is the head of the National Audit Office employing some 750 staff. He, and the National Audit Office, are totally independent of Government. He certifies the accounts of all Government departments and a wide range of other public sector bodies; and he has statutory authority to report to Parliament on the economy, efficiency and effectiveness with which departments and other bodies have used their resources.

# Contents

<b>Executive summary</b>	<b>1</b>
Conclusions	5
<hr/>	
<b>Part 1: Introduction</b>	<b>7</b>
Why was the married quarters estate sold?	9
What were the objectives for the sale?	11
What are the main features of the sale?	11
What were the scope of, and methods for, the National Audit Office examination?	13
<hr/>	
<b>Part 2: How the Department structured and managed the sale</b>	<b>14</b>
What was sold	14
What rent will the Department pay?	17
How are management responsibilities allocated under the sale?	19
Did the Department obtain professional advice?	22
How did the Department manage the competition process?	24
What were the arrangements for payment	30
What were the costs of the sale?	31
<hr/>	
<b>Part 3: How the Department decided whether to proceed with the sale</b>	<b>33</b>
How did the sale price compare with valuations of the estate?	33
How did the financial implications of the sale compare with the Department retaining ownership?	34
What was the Department's overall assessment on proceeding with the sale?	49
<hr/>	
<b>Part 4: How the Department have protected their future interests</b>	<b>50</b>
How will rent reviews be conducted?	50
Are there arrangements for the Department to share the benefits of any future gains by the new owners?	51
What are the arrangements for terminating underleases?	53

---

**Appendices**

1. Chronology of the sale	56
2. National Audit Office methodology	59
3. Summary of Committee of Public Accounts recommendations and Treasury guidance on property sales	61
4. Procurement method, type of contract and expenditure in relation to the Department's main advisers	68
5. The Department's investment appraisal	71
6. Clawback provisions	76

## Executive summary

**1** This Report examines the sale by the Ministry of Defence (the Department) of their married quarters estate in England and Wales to the Annington Group of companies for £1,662 million. The Department lease back those married quarters they require. The Department's objectives for the sale were:

- a) to transfer to the private sector property which the Department did not need to own themselves;
- b) to improve management of the quarters through greater involvement of the private sector;
- c) to secure improvement in the quality of married quarters, by raising sufficient funds to upgrade the bulk of quarters in the United Kingdom to 'grade-one' condition; and
- d) to secure value for money through a competitive sale.

**2** The Department set pre-conditions for the sale:

- a) a price which reflected the public interest; and
- b) terms which gave the Department sufficient contractual protection and satisfied the interests of the Services.

**3** **On the objective of transferring to the private sector property which the Department did not need to own themselves, the main findings were:**

- a) The Department have transferred nearly four-fifths of their married quarters in the United Kingdom to private sector owners. The sale excluded all quarters in Scotland and Northern Ireland. It also excluded a tenth of those in England and Wales mainly because some sites were in the process of being disposed of, or were used by United States forces (paragraphs 2.3-2.6).

**4 On the objective of improving the management of the quarters through greater involvement of the private sector, the main findings were:**

- a) The new arrangements give the Department an incentive to identify and surrender surpluses to allow them to cease rental payments, and they will have certainty about the timing and extent of such savings. There were also incentives before the sale, when the Department received the proceeds from the disposal of individual quarters (paragraphs 2.13-2.14).
- b) Important management tasks remain with the Department. They are responsible for the management of maintenance, upgrading quarters and allocating Service families to specific quarters. The Department excluded maintenance from the sale because they were concerned that lack of reliable historical data on maintenance activity might prompt disproportionately lower bids for the sale. Also, they did not want to risk fragmenting the task, creating anxiety amongst Service families about future maintenance standards and over-complicating and possibly delaying the sale (paragraphs 2.10-2.11).

**5 On the objective of securing improvement to the quality of married quarters, the main findings were:**

- a) £100 million of the sale proceeds will be added to the Department's existing budgets for upgrading married quarters. The Department do not intend to upgrade those quarters earmarked for surrender to Annington within the next five years (paragraph 2.12).

**6 On the objective of securing value for money through a competitive sale, the main findings were:**

- a) The Department issued over 5,000 copies of a preliminary information memorandum on the estate, received 19 formal bids for the estate and maintained competitive tension up to the point of exchange of contracts. In the first round of bidding, the Department decided not to pursue two high price indicative bids on the basis of their advisers' assessment against predetermined evaluation criteria. In the subsequent and final stages, the Department chose the highest price bid (paragraphs 2.23-2.31).
- b) The Department used external advisers and agents to assist with the key areas of the sale. Of the eight largest contracts, seven were let following competition. The total cost of the sale, including in-house staff costs, was £12.6 million - £2.4 million less than budgeted - and represented less than one per cent of the

sale proceeds. The Department previously spent £7.6 million on an aborted Housing Trust scheme, the immediate forerunner of the sale (paragraphs 2.17-2.19 and 2.39-2.40).

**7 On the pre-condition that the price should reflect the public interest, the main findings were:**

- a) The Department identified benchmarks to assess the net financial benefits of proceeding with the £1,662 million sale:
- i External advisers (Savills) valued the properties sold at £1,820 million, on the basis of individual disposals and with immediate vacant possession. As the Department intended to remain in occupation of the bulk of the estate, and because the likely sale price would be determined by opportunities for revenue generation for the new owners, advisers also assessed the value of the sale from the perspective of potential purchasers. On the basis of the rates at which surplus quarters might be surrendered by the Department, Savills' broad appraisal of the value of the sale (this was not an estate valuation in accordance with normal Royal Institution of Chartered Surveyors practice) was about £1,350 million to £1,500 million (the sale price achieved was £162 million to £312 million higher). And on the basis of likely cash-flows for a new owner, NatWest Markets estimated that the sale was worth £1,480 million - the sale price achieved was £182 million more (paragraphs 3.2-3.4).
  - ii The Department compared the sale price with the financial consequences of a range of scenarios for continued in-house ownership of the estate, which they valued at between £1,712 million and £1,974 million. The sale price was £77 million to £139 million lower than the value under the main comparator used by the Department. They tested the sensitivity of this assessment, which indicated that the sale price would only exceed the value of continued in-house ownership of the estate if growth in real property values remained low, or the number of quarters leased by the Department fell further than expected. The National Audit Office calculated that it would have to fall from 55,000 to about 21,000 over the next 25 years (paragraphs 3.5-3.15).
  - iii In most respects the characteristics of the sale point to risks being transferred to the new owners. They bear the risks associated with the release of surplus quarters from the Department and with future property values. The Department will continue to be responsible for maintenance and bear the risk associated with possible volatility in market rents. Other, quantifiable, indicators also point to the transfer of risk to the new owners

- numeric tests for the accounting treatment, and value for money, of leases; a rate of return for the new owners in excess of that generally available from risk-free investments; and a sixth of their funding comprising risk capital (paragraphs 3.16-3.27).

**b)** Overall, the results of the Department's analysis were that the purchase price was lower than the benchmark range of values for continued Departmental ownership, which reflected transfer of risk to the new owners. Ministers accepted the £1,662 million bid, as a price which properly reflected the public interest (paragraph 3.28), on the basis that:

- i** the ownership of property did not form a core element of Defence business and the sale offered the opportunity to release from public ownership this large residential portfolio, and thereby the risks associated with its ownership;
- ii** the new owners would be better placed to manage the properties which fall surplus, and release them for use by others;
- iii** the sale would release funds for the upgrade programme at a rate which could not otherwise be achieved, and was the only way in which the necessary upgrade of the estate could be achieved in the short-term;
- iv** the possibility of downstream opportunities and efficiencies from partnership with the new owner;
- v** the understanding of, and sensitivity to, the Services' concerns about the management of the estate which Annington had shown; and
- vi** the Department's assessment that, within the sale option, the price was the best which a good competition could extract from the market.

**c)** The sale price was divided into two payments, which were paid in full and on time. If the sale price reflected fully the benefits to the purchaser of the deferral of the second payment there was no loss to the Exchequer and possibly a gain; if it did not, the loss of interest to the Exchequer could have been up to £27 million. The Department did not establish whether the sale price reflected the deferral. To do so would have involved also seeking bids on a single payment basis, but the Treasury's request for the deferral precluded such an approach (paragraphs 2.35-2.36).

**8 On the pre-condition that the sale terms would protect the Department and satisfy the Services, the main findings were:**



- a) Under the sale contract, the rents paid by the Department will be aligned to market rents, and based on negotiation. There is provision for arbitration, if needed. There is also a clawback provision to provide the Department with a share of disposal profits over the next 15 years, and as at June 1997 the Exchequer had received £1.25 million through these arrangements (paragraphs 4.2-4.11).
- b) The new owners cannot terminate the Department's leases on sites that are in secure areas. For other sites, the new owners may terminate underleases at breakpoints, the first arising after 25 years. They will have to be able to demonstrate an intention and ability to redevelop, however, or offer alternative sites on closely-drawn comparability criteria. The Department may exercise a veto on terminations for redevelopment which would severely prejudice the operational effectiveness of the associated military base, and for terminations for redevelopment that do proceed the Department will have four years' notice and compensation worth two years' rent. The Department will have to continue to provide utility services for sites they surrender in the next 25 years, if they are dependent on adjacent sites for such services. Alternatively, the Department may pay towards the cost of new services up to an estate-wide £25 million limit (paragraphs 4.12-4.18).

## Conclusions

- 9 The National Audit Office reached the following overall conclusions:

### Conclusion 1

The following objectives for the sale were achieved: The sale was competitive; it transferred ownership of nearly four-fifths of the married quarters estate in the United Kingdom to the private sector; and it provided funds to upgrade below-standard quarters.

## **Conclusion 2**

As regards the objective of improving the management of the married quarters, the sale has provided the Department with a financial incentive to identify and surrender surpluses. There were, though, different incentives to dispose of surpluses before the sale, and the Department will have to monitor the effectiveness of the new arrangements. Significant responsibilities have been retained by the Department, including maintenance, which remain unaffected by the sale.

## **Conclusion 3**

The sale price exceeded the Department's advisers' assessments of the likely value of the sale transaction from the perspective of potential purchasers, but was below the Department's benchmark values for retaining ownership of the married quarters. Proceeding with the sale rested, ultimately, on securing a competitive price for assets that the Department did not need to own, and other policy benefits.

## **Conclusion 4**

The sale process itself was well managed, and while looking to make the sale attractive and give new owners opportunities to develop the estate, the Department have also sought to protect their future interests.

## Part 1: Introduction

**1.1** On 5 November 1996 the Ministry of Defence (the Department) completed the sale of their married quarters estate in England and Wales to the Annington Group of companies. The consortium backing the Group comprised Nomura International plc, Amec, BlackRock UK Partners, Electra Fleming Ltd, Abbey National Treasury Services, Hambros Bank, the Midland Bank and the Royal Bank of Scotland.

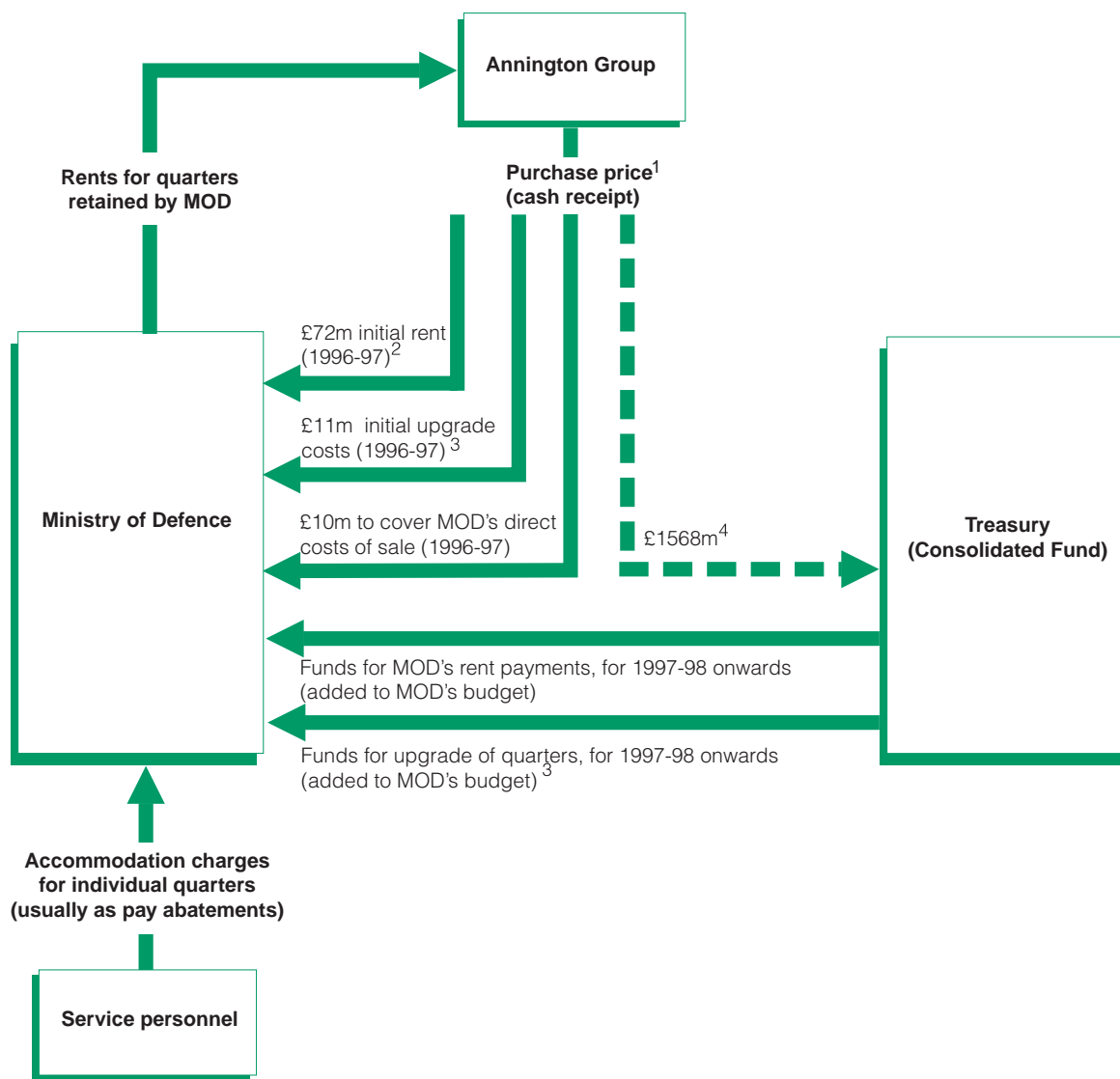
**1.2** The sale, which was by competitive tender, resulted in:

- a) a cash receipt of £1,662 million (£962 million on completion in November 1996, and a further £700 million on 1 April 1997);
- b) immediate disposal of the freehold of over 2,000 married quarters surplus to the Department's requirements, for which little or no disposal action had been begun. For the remaining 55,000 quarters, which were sold on 999-year headleases and then leased back by the Department on 200-year underleases, the sale also gives them the ability to surrender surplus quarters at six months' notice (in the first year following the sale, the Department were planning to surrender 700 quarters). The new owners bear the uncertainty relating to the number, location and value of surplus properties to be surrendered by the Department, and when they might be surrendered (subject to a guaranteed minimum number); and
- c) the Treasury agreeing to make available to the Department £100 million of the sale proceeds to fund a programme of improvements over the next five to seven years, to bring the bulk of married quarters up to 'grade-one' condition.

**1.3** The resulting financial transactions affecting the Department are summarised in Figure 1. The accommodation charges paid by Service personnel are not related to the rents paid by the Department to the Annington Group, because they are fixed by the Department on the basis of recommendations by the Armed Forces Pay Review Body which aims to equate Servicemen's accommodation charges to comparable civilian housing costs.

**Figure 1**

**Main monetary flows in connection with the sale**



Notes: 1 The purchase price consisted of two payments: £962 million on completion and £700 million on 1 April 1997.

2 The Department's rent payments are paid quarterly in advance - initially £28 million a quarter, or £111 million a year. This means that by 1 April 1997, the Department had paid £72 million (£16 million abated from the first tranche of the sale price, for the period 5 November to 31 December 1996; £28 million on 25 December 1996 and £28 million on 25 March 1997). The House of Commons Defence Committee had noted that the £72 million was not in proportion to the 5 month period from the sale completion to 1 April 1997. This is because of advance payment of the quarterly rentals.

3 In total, £100 million added to the Department's budget (and 'ring fenced'), to supplement existing budgets for the upgrading of married quarters.

4 £641 million was surrendered to the Consolidated Fund. The remaining £927 million contributed to Exchequer funds, although in practice the cash was used by the Department: some to help meet funding commitments to the Department in respect of the extra costs of operations in Bosnia and in respect of the carry-over of an underspend on the previous year's Defence budget; and some being used to reduce the funding of the 1997-98 Defence budget drawn from the Exchequer.

Source: National Audit Office

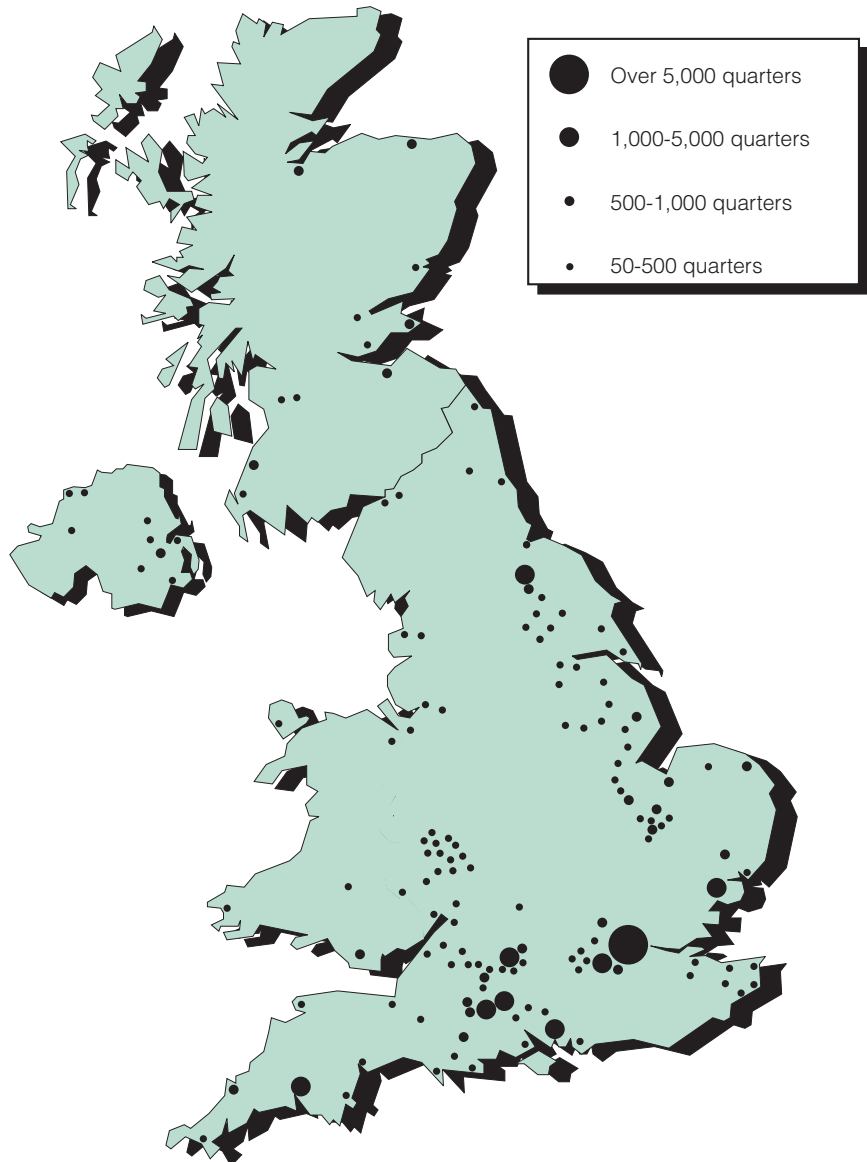
Figure 1 shows the main cash payments and budget adjustments arising from the sale of the married quarters estate.

## Why was the married quarters estate sold?

**1.4** The Department’s policy is to provide sufficient, good quality houses in the right locations for those Service personnel and their families who wish to live in married quarters (Figure 2 shows the location of the quarters in the United Kingdom). They consider the ready availability of appropriate housing as fundamental to morale, welfare and, ultimately, operational effectiveness. However, they consider that to meet these aims it is not necessary for them to own properties themselves.

The main locations of the married quarters in the United Kingdom

**Figure 2**



Source: Ministry of Defence Figure 2 shows the location of the main married quarters sites in the United Kingdom.

**1.5** The Department will continue to meet new requirements for married quarters - in new locations, or more quarters in existing locations - and estimate a need for up to 500 new married quarters a year in the short term. They intend to rent them in the market or let contracts for private sector construction under the private finance initiative, in which case the properties will not be owned by the Department.

### **What was the backdrop to the sale?**

**1.6** In 1992 the Department's 'Housing Task Force' had concluded that the quality of married quarters was inadequate and that, with a high level of empty quarters, they were not managed as efficiently as they could be. The Department consider that they need to keep a proportion of married quarters empty mainly to allow them flexibility in accommodating Service families being posted, currently about 13 per cent although they aim to reduce this to ten per cent. But in the five years before the sale, between 13 and 20 per cent of married quarters had been empty, and at the time of the sale some 12,000 (19 per cent) of the 64,000 married quarters in England and Wales were empty.

**1.7** The Housing Task Force had recommended setting up a Housing Trust to improve the management of the married quarters estate, by introducing a customer-supplier relationship with the Services. The Housing Trust would have been a non profit-distributing chartered corporation, owning and maintaining the married quarters and leasing back to the Department those they required. The Trust would have been able to let surplus properties to third parties and retain part of the proceeds from selling surpluses.

**1.8** The level of control which the Department would have had over the Trust was too great for the emerging proposals to be accepted by the Central Statistical Office (now the Office for National Statistics) as a genuine transfer of ownership and risk to the private sector. So in August 1994 the Department abandoned the proposals for a Housing Trust and began developing an outright sale of the married quarters to a body that would be unambiguously in the private sector.

**1.9** The chronology of the sale is at Appendix 1.

## What were the objectives for the sale?

**1.10** When they developed their sale proposals in November 1995, the Department's objectives were:

- a) to transfer to the private sector property which the Department did not need to own themselves;
- b) to improve management of the quarters through greater involvement of the private sector;
- c) to secure improvement in the quality of married quarters, by raising sufficient funds to upgrade the bulk of quarters in the United Kingdom to 'grade-one' condition;
- d) to secure value for money through a competitive sale.

**1.11** The Department set pre-conditions for the sale:

- a) a price which reflected the public interest; and
- b) terms which gave the Department sufficient contractual protection and satisfied the Services' interests - in particular the requirement for future operational flexibility.

## What are the main features of the sale?

**1.12** The main elements of the sale are summarised in Box 1 below.

The main elements  
of the sale

### Box 1

- a) the transfer to the new owners of the freehold of 2,373 empty, and immediately surplus, quarters ('the surplus estate'); and the sale of 55,055 married quarters used by the Department (the 'retained estate') on 999-year headleases (one for each of the 739 sites);
- b) the Department leasing back the quarters on 739 two-hundred year underleases, and paying rent quarterly in advance (subject to minimum guaranteed payments for the first 25 years). There are arrangements for a rolling programme of rent reviews at five-year intervals, based on open-market rent comparisons;

continued...

---

**The main elements  
of the sale  
(continued)**

- c) the Department being able to terminate underleases at any time with six months' notice, with a guaranteed minimum number of quarters to be surrendered. When surrendered, the new owners will be able to acquire the freehold from the Department;
  - d) except for sites located within security areas ("behind the wire"), the new owners having the right to terminate underleases at breakpoints falling between the 25th and 28th year, and every fifteen years thereafter, if they intend to redevelop the site or if they offer another comparable site in exchange. The Department have a veto against termination on redevelopment grounds, however, if retention by the Department is necessary for operational reasons;
  - e) an obligation on the Department to continue to provide utilities - mainly electricity, gas, water and sewerage services, on repayment terms, to sites they surrender in the first 25 to 28 years which depend on adjacent bases for these services. Alternatively, the Department may contribute to the cost of installing 'public' utility services, up to a maximum of £25 million across the estate;
  - f) the Department having to provide access to sites located "behind the wire" if they choose to surrender properties on such sites to the new owners. Some 11,000 quarters are currently behind the wire - a fifth of those 'retained';
  - g) the Department bearing a contingent liability to meet up to £50 million of the new owners' costs arising from any difficulties in establishing title to the properties that might result from inaccurate or deficient information from the Department. The new owners may lodge a claim only for total costs of £10 million or more, and claims may only be made in the first two years after the sale;
  - h) the Department retaining an interest, through clawback arrangements, in future profits by the new owners; and
  - i) the Department retaining responsibility for maintenance standards, and for directing maintenance and upgrading of Service housing.
-



## **What were the scope of, and methods for, the National Audit Office examination?**

**1.13** Against this background the National Audit Office examined how the Department managed the sale, and whether they achieved their objectives. The report is split into the following parts:

**Part 2** - how the Department structured the sale and managed the sale process;

**Part 3** - how the Department decided whether to proceed with the sale;

**Part 4** - how the Department have sought to protect their future interests.

**1.14** The methodology used by the National Audit Office is summarised at Appendix 2. They evaluated the sale against good practice they distilled from past reports by the Committee of Public Accounts and from Treasury guidance (Appendix 3). They also sought the views of the final four shortlisted bidders, whose views on specific aspects of the sale are given throughout this report.

## Part 2: How the Department structured and managed the sale

**2.1** This Part examines how the Department defined the main components of the sale and managed the sale process. Specifically, it focuses on the following aspects:

### The aspects examined in this Part

- what was sold
- the rent payable under the sale
- the allocation of management responsibilities under the sale
- the use of professional advice
- the competition process
- the arrangements for payment
- the costs of the sale

### What was sold?

**2.2** In preparing the sale package, the Department noted that small disposals over time might in theory generate bigger aggregate receipts. They decided instead to pursue a single, bulk sale to a single purchaser, following advice from NatWest Markets that a single sale:

- a) would be simpler, quicker and cheaper overall to implement;
- b) would be more attractive to some potential purchasers, including investment banks and overseas investors. Other potential purchasers, though, might find difficulty in financing such a large deal;

- c) would avoid the likelihood of the Department being left with a residue of houses that might be difficult to sell;
- d) would maximise flexibility in leasing back properties; and
- e) would provide a firmer basis for establishing the significant minimum occupancy and payment commitments that were a fundamental part of the proposed sale structure.

**2.3** Figure 3 shows how many married quarters in the United Kingdom were included in the sale. The Department excluded from the sale properties in Northern Ireland (reflecting the special circumstances in the province) and Scotland (for legal and operational reasons). In addition, some 6,300 properties in England and Wales (ten per cent) were excluded.

## **Scotland**

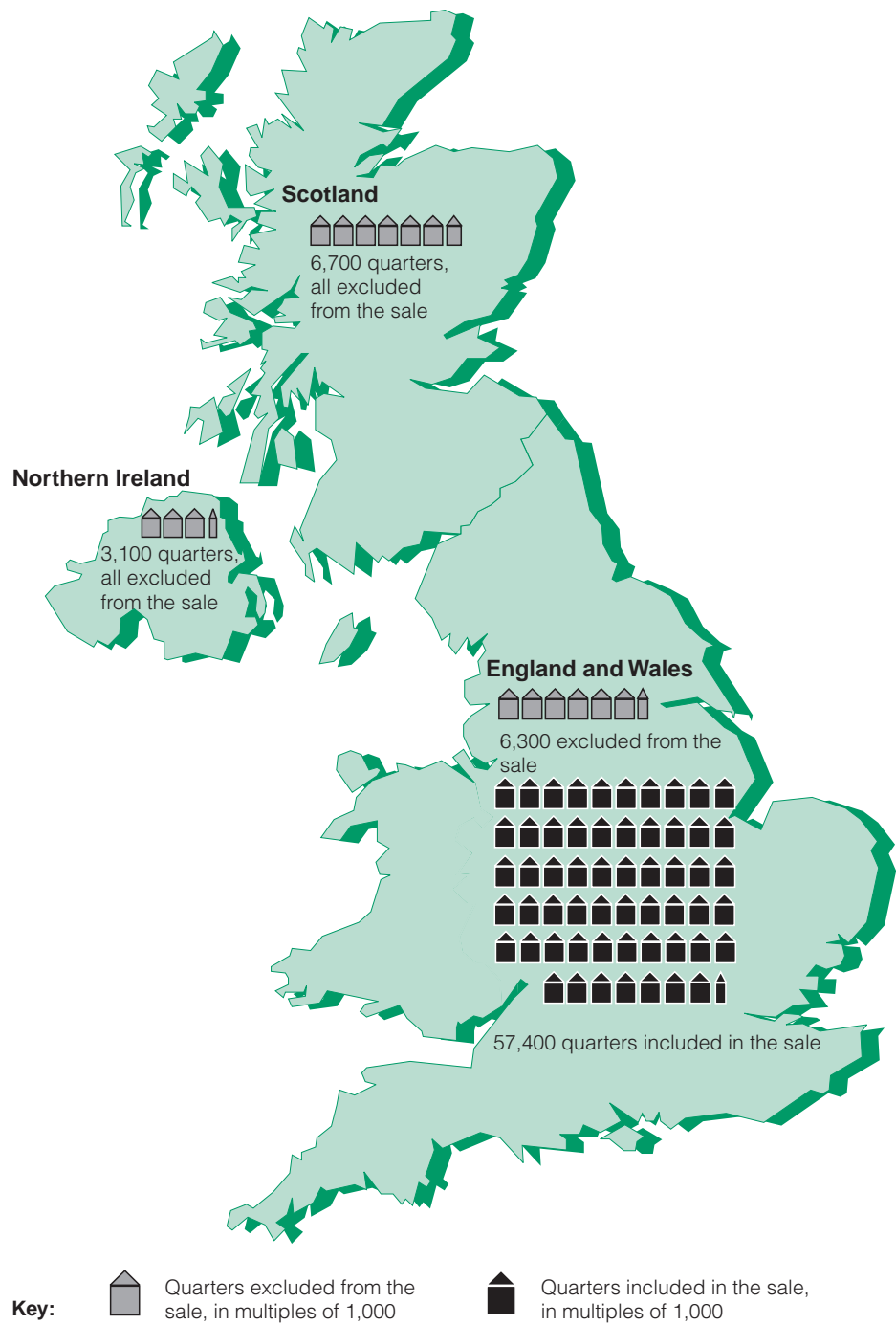
**2.4** Scottish law generally prohibits residential property being the subject of leases of more than 20 years, with no right of renewal by the tenant - there are no time limits for leases in England and Wales. So in Scotland, the Department's ability to occupy sites after 20 years at an affordable rent would have depended on negotiation with the landlord at that time, and the Department concluded that the remoteness of many locations meant that the availability of sufficient reasonably-priced alternative rental accommodation would be unlikely. The Department considered other options to extend their security of tenure, but their Scottish legal advisers, Maclay Murray and Spens, concluded that these were not feasible under existing Scottish law.

## **England and Wales**

**2.5** The 6,300 properties in England and Wales excluded from the sale included some 1,500 already in the process of being sold or leased by the Department, and some 3,000 quarters provided for United States visiting forces. The Department had to exclude half of the official service residences, either because they did not own them or because the properties could not satisfactorily be physically separated from surrounding non-residential facilities. Some 500 high value properties were included, however, including 16 official service residences. The Department considered that the encouraging effect that their inclusion would have on bids would more than outweigh the gains that might be made by the Department 'cherry-picking' these properties and selling them separately.

**The married quarters estate, and those quarters included in the sale**

**Figure 3**



Source: Ministry of Defence

Figure 3 shows that all quarters in Scotland and Northern Ireland were excluded from the sale, and a tenth of those in England and Wales.

## Main points

**2.6** The Department included in the sale nearly four-fifths of the married quarters in the United Kingdom; and excluded those in Scotland and Northern Ireland and a tenth of the quarters in England and Wales.

## What rent will the Department pay?

**2.7** The sale was on the basis that the Department would pay the new owners rent for those properties they lease back. The Department decided on quarterly rents, paid in advance, to reflect commercial practice, and their aim was that rents would reflect market rates. The initial rent was based on assessments by the Department's property advisers of 'Assured Shorthold Tenancy' rents payable on similar properties, aggregated across the estate and then discounted by 58 per cent to reflect the bulk nature of the lettings and certain features of the Department's occupation (Box 2).

### The discount on the Department's rent

#### Box 2

The rent the Department pay is the sum of the rents for the leased-back properties, assessed individually on an open-market valuation (with reference to the Assured Shorthold Tenancy market) and discounted to reflect certain features of the Department's occupation of the estate. The Department, with their financial and property advisers (NatWest Markets and Savills), fixed a discount of 58 per cent, to reflect:

	<b>Discount</b>
i) the Department's continuing maintenance obligations	<b>28%</b>
<hr/>	
ii) the bulk nature of the lettings, reflecting both the size of individual sites and the estate as a whole.	
iii) the quality of the Department's covenant - that is, the assurance new owners could take that the Department, as tenant, would not default on their rent payments.	<b>20%</b>
<hr/>	
iv) the benefit, to the purchaser, of the Guaranteed Payments	<b>10%</b>
<b>Total discount</b>	<b>58%</b>

**2.8** To help avoid bidders unnecessarily reducing their bids because of uncertainty about the number of quarters to be leased by the Department, the Department underpinned the total rent payments by guaranteeing quarterly minimum payments (worth £107 million in the first year) for the first 25 years, declining year by year (Figure 4). The Department set these payments below the rent implied by the number of married quarters they anticipated leasing. The minimum payments are fixed cash sums, so with inflation their value will decline further in terms of the number of leased properties they imply. In the first year, the Department’s estimated rent is £111 million - £4 million above the minimum. The

**Guaranteed payment profile**

**Figure 4**

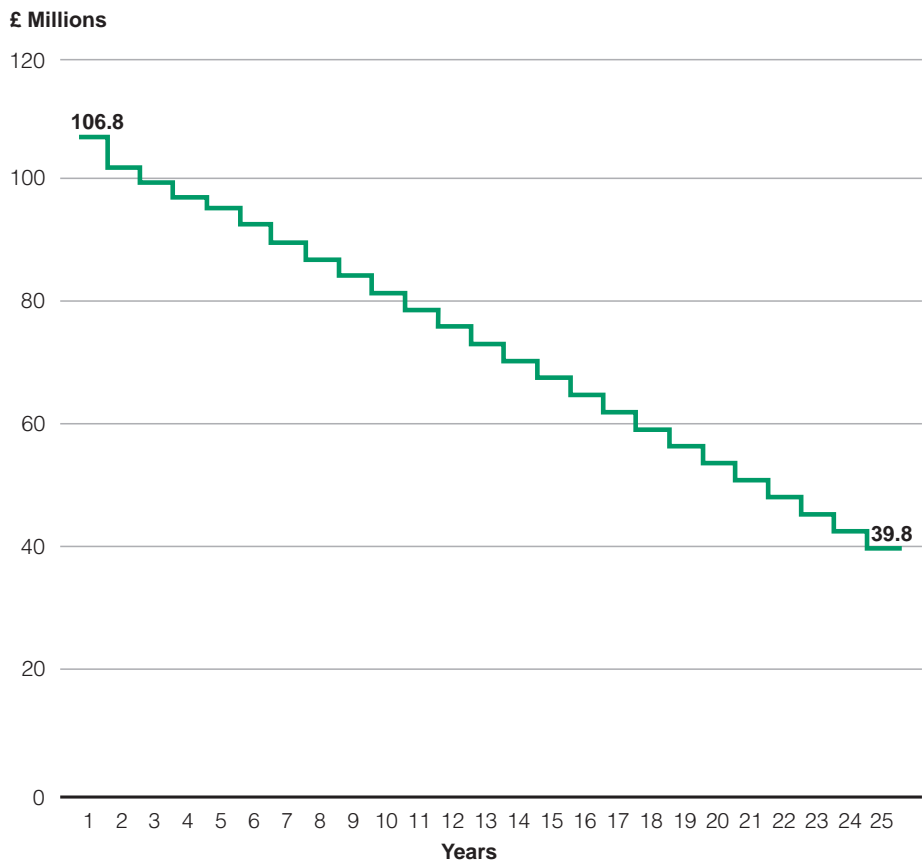


Figure 4 shows the guaranteed payments which apply in the first 25 years after the sale. They are fixed in cash terms, and decline steadily from nearly £107 million in the first year to nearly £40 million in the last year.

Figure 12, later in this report, shows how the number of quarters leased by the Department relates to the number implied by the guaranteed payment profile, taking account of the Department’s estimates for general- and rent-inflation.

Source: Ministry of Defence

rent covers all married quarters leased by the Department, including those unoccupied; the Department's aim is to reduce the level of empty quarters at any time ultimately to 10 per cent (paragraph 1.6).

## **Main points**

**2.9** The main points are:

- a) To help avoid bidders unnecessarily reducing their bids because of uncertainty about the number of quarters the Department would lease, minimum payments were built into the sale.
- b) The rents paid by the Department subsume a significant discount reflecting, amongst other things, the Department's continuing responsibility for maintenance and the minimum guaranteed payments.

## **How are management responsibilities allocated under the sale?**

### ***The Department's responsibilities***

**2.10** Following the abandonment of the Housing Trust proposals, the Department established the Defence Housing Executive in April 1995 to bring early improvement to the in-house management of the married quarters estate. The Executive became the Department's main point of contact with the new owners following the sale. They are responsible for directing the maintenance and upgrading of those houses leased back from Annington, the identification of surplus quarters, works services needed to separate surplus sites from adjacent bases before their disposal, and the allocation of specific houses to individual Service families. They are also responsible for notifying Annington about quarters to be surrendered and arranging their transfer, negotiating the rent reviews and policing the clawback provisions.

**2.11** The National Audit Office looked into why the Department retained management responsibility for maintaining and upgrading those houses leased back from Annington, and noted that:

- a) The Department's advisers (NatWest Markets) had considered that excluding maintenance would avoid over-complicating an already novel sale transaction. They had also advised that including maintenance could significantly lengthen the sale process because without detailed and reliable historical data on the costs of maintaining the quarters and on their condition, bidders would need more time to deliberate on the risks and financial implications. The

Department considered that, had maintenance been included, these weaknesses in the historical data would have prompted disproportionately poorer bids;

- b) The Department, the Services and Service wives' associations, considered that the Defence Housing Executive retaining responsibility for maintenance would give assurance to Service families that maintenance standards would not be eroded, and planned improvements would be carried out; and
- c) The Department took the view that privatising the maintenance function as part of the sale might result in fragmentation of maintenance and other estate management responsibilities, which the Defence Housing Executive had been established to bring together. And it might involve the Department having to terminate some of their existing local maintenance contracts, at additional cost.

**2.12** Before the sale, the Department's planned expenditure for upgrading married quarters over the five years to 2001-02 had been £370 million. Savills, the Department's property advisers, estimated that of the order of £470 million was needed to bring all quarters up to standard. On this basis, the Treasury have agreed to add, and 'ring fence', £100 million to this budget for the Department to bring the bulk of married quarters in the United Kingdom up to 'grade-one' condition over a five to seven year period. The Department are now undertaking a detailed condition survey of all quarters to identify where, and what, work is needed, and its cost. They plan not to upgrade those quarters earmarked for surrender in their Long Term Housing Plan, which each year looks five years ahead.

### ***The new owners' responsibilities***

**2.13** The new owners will have some tightly circumscribed opportunities, described in Part 4, to take possession of quarters that they wish to redevelop, at breakpoints in the underleases which arise after 25 years and at 15 year intervals thereafter. More generally, their main estate management role is in dealing with surplus quarters surrendered by the Department. The Department need give only six months' notice, after which their rental payments and maintenance responsibilities cease and the new owners carry the financial consequences of how quickly and successfully the quarters are sold-on, re-let or redeveloped.



**2.14** The Department established these arrangements to provide for themselves a clear incentive to identify and surrender surplus quarters - doing so would provide a clearly identifiable saving on their rent payments, achievable in six months without the administrative effort and cost of conducting the sale. The Department had different financial incentives to identify and sell surplus quarters before the sale of the married quarters estate, in that they would benefit from the proceeds of selling surplus individual quarters, although the value and timing of receipts was uncertain and the Department incurred the costs of sale. Box 3 compares the arrangements before and after the sale.

**The gains available to the Department from identifying and disposing of surplus quarters, before and after the sale of the married quarters estate**

### Box 3

#### *After the sale*

- The Department are able to cease rent payments. They may also have a share of profits on disposals by the new owners in the next 15 years.
- Certainty about the amount and timing of the ceased rental payments.
- The main administrative effort for the Department, and costs, concern making sites ready for surrender.

#### *Before the sale*

- The Department were able to receive the proceeds from the sale of individual quarters.
- Uncertainty about the amount of sale proceeds, or how quickly these might be realised.
- The Department's costs included selling costs, as well as those of making sites ready for disposal. Significant and protracted work was often needed to dispose of sites, particularly if in unattractive locations or in poor condition.

### Main points

**2.15** The main points are:

- a) The Department continue to be responsible for, and pay for, maintaining the retained quarters, and will have available £100 million from the proceeds of the sale to upgrade the bulk of married quarters to 'grade one' condition.

- b) The Department excluded maintenance from the sale because they were concerned about the risks of fragmenting maintenance and other management tasks, creating anxiety amongst Service families about maintenance standards, over-complicating and possibly delaying the sale, and bids being reduced disproportionately as a result of uncertain data on past maintenance costs.
- c) The new owners' management responsibilities are concerned with dealing with quarters surrendered by the Department. The Department have a financial incentive to surrender surpluses, to allow them to cease rental payments, and they will have certainty about the timing and extent of such savings. The Department will have to monitor the new arrangements to ensure that they provide effective incentives to identify and surrender surplus quarters.

## **Did the Department obtain professional advice?**

**2.16** Against the background of recommendations by the Committee of Public Accounts, and Treasury guidance, the National Audit Office examined whether: advisers had been appointed for key sale tasks; they had been appointed following competition; and budgets had been used to control costs.

**2.17** The National Audit Office found that the Department had sought extensive external advice in developing their sale proposals, and engaged consultants to assist with key areas of the sale process, including financial, legal and property aspects (Figure 5).

**2.18** The National Audit Office examined the extent of competition in appointing the eight advisers and agents on whom, individually, the Department spent over £100,000 (accounting for over 90 per cent of the total cost of external assistance). They also examined, for these cases, the type of contract used and expenditure incurred, and the details are given in Appendix 4.

**2.19** This analysis (Appendix 4) showed that contracts were generally let following competition. The exception was the appointment of the Government Property Lawyers, whom the Department considered best placed to investigate title and arrange conveyancing (the Government Property Lawyers held the title deeds, and had already undertaken initial work to investigate property title as part of the Housing Trust scheme). Two advisers - Savills and Coopers & Lybrand - worked on the sale without competition, although they had been retained after earlier work in developing the Housing Trust proposals for which they were selected after competition. Nearly all contracts involved time-based fees, although

**The Department's main advisers on the Sale**

**Figure 5**

*Financial and Accountancy advisers*

NatWest Markets - main financial advisers and selling agents  
Coopers and Lybrand  
Price Waterhouse

*Legal advisers*

Herbert Smith - main legal advisers  
Government Property Lawyers  
Henderson Boyd Jackson  
Robson McLean  
Maclay Murray Spens

*Property advisers*

Savills

*Utilities advisers*

Sir Alexander Gibb and Partners Ltd

*Public relations advisers*

Brunswick

most also specified upper fee limits for individual tasks. The Department state that fees were capped wherever possible. Their main financial and sale advisers were paid in part on the basis of a commission on the sale price achieved.

**2.20** The National Audit Office noted that during the sale the Department monitored the costs of external advisers and agents, against an overall budget, on a monthly basis. The Department spent £11 million overall on advisers and agents for the sale - £2.5 million less than budgeted, although expenditure on some items varied from the Department's initial estimates (Appendix 4). Main areas of higher than expected expenditure included:

- a) principal legal advisers (Herbert Smith) - £1.6 million higher (97 per cent). This included the transfer of £800,000 of work initially earmarked for other legal advisers, and £500,000 which had been separately budgeted for organising the 'data room' (paragraph 2.26);
- b) principal financial advisers (NatWest Markets) - £564,000 higher (14 per cent), a result mainly of higher than expected total commission payments linked to the sale price achieved; and

c) principal property consultants (Savills) - £130,000 higher (13 per cent).

Lower than expected expenditure included:

d) accountancy advisers (Price Waterhouse) - £315,000 lower (75 per cent); and

e) environmental consultants - £500,000 estimated but not spent because the Department found it unnecessary to carry out environmental surveys.

## Main points

**2.21** The main points are:

a) The Department used external advisers and agents extensively, to assist with the key areas of the sale. The main contracts for this input were generally let following competition.

b) The Department set a budget for, and monitored the cost of, their advisers and agents. There were some variations against the Department's initial estimates of expenditure. Overall, however, the cost of consultants was £11 million, 2.5 million less than the budget.

## How did the Department manage the competition process?

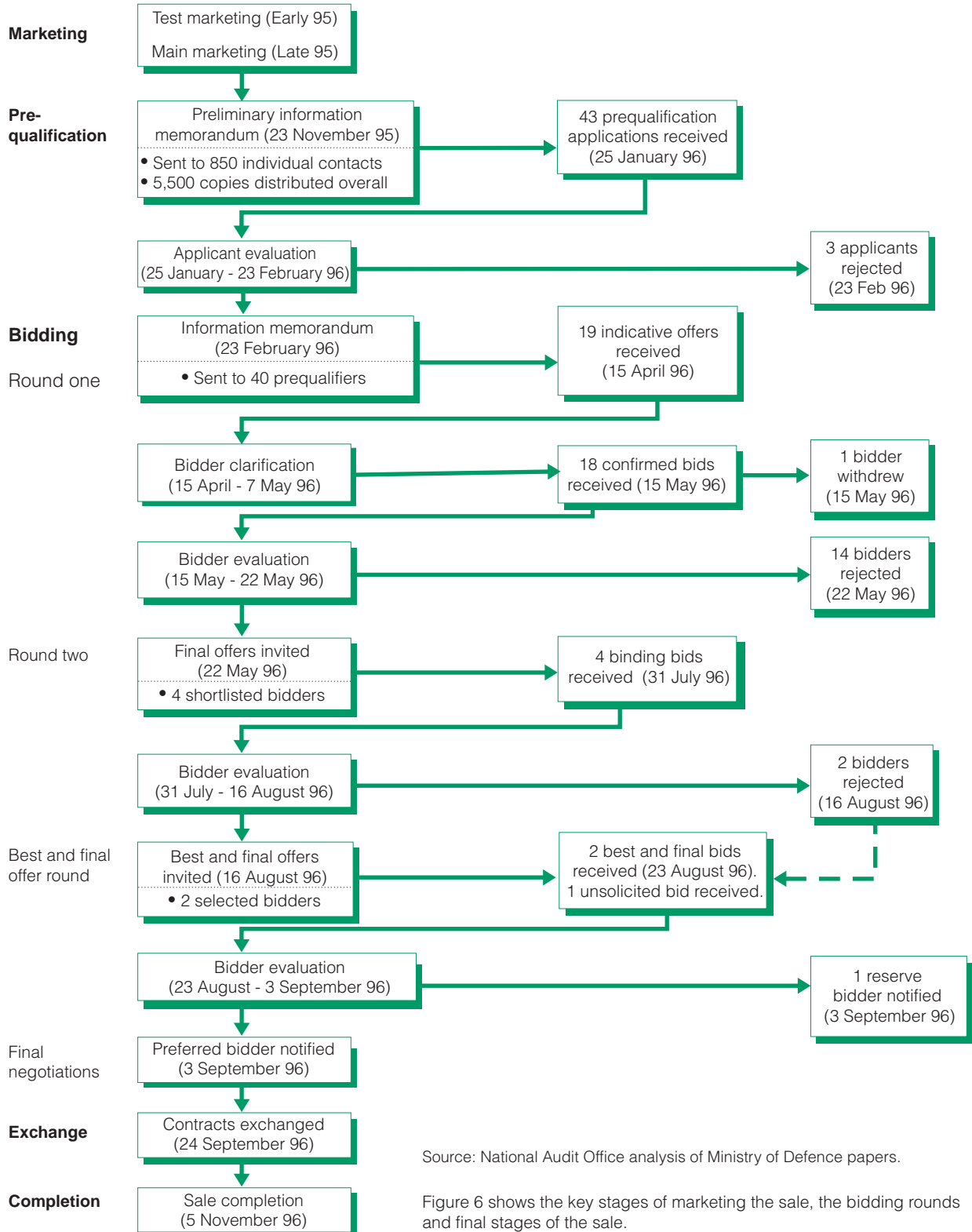
**2.22** The National Audit Office examined how the Department planned the marketing and bidding process; marketed the sale to maximise interest and maintain competitive tension throughout the sale; the time and opportunities given to bidders to visit sites, research the sale and formulate their bids; and how the Department evaluated the bids received to secure the best price and other terms.

**2.23** The Department used consultants to generate, measure and maintain significant interest in the market, and to help shape the Department's approach to the sale. This involved: initial test marketing; then issuing some 5,500 copies of a Preliminary Information Memorandum, including overseas, to elicit applications to prequalify for the sale; and then issuing a full Information Memorandum to 40 successful prequalification applicants.

**2.24** Following the prequalification stage the Department planned to have three main bidding rounds, to maintain competitive tension between bidders and maximise the sale price. The main bidding rounds (Figure 6) were to be:

**Figure 6**

**The sale process**



Source: National Audit Office analysis of Ministry of Defence papers.

Figure 6 shows the key stages of marketing the sale, the bidding rounds and final stages of the sale.

- a) a first round, to generate non-binding offers from a pool of interested parties;
- b) a second round, to secure binding offers from a pool of shortlisted bidders; and
- c) final negotiations with a preferred bidder.

In the first round, the Department received 19 indicative offers. This was more than they had anticipated, and they gave the bidders six days to reconsider and improve their initial offers. The Department also added a 'best and final offer' round, giving two of the last four consortia a week to reconsider and improve their second round offers.

**2.25** It is important to give interested parties sufficient opportunity to prepare sound proposals. The Department gave potential bidders eight weeks to respond to their Preliminary Information Memorandum and apply to pre-qualify, seven weeks to submit first round bids and ten weeks for second round bids (Figure 6). The Department's advisers (NatWest Markets) considered that the periods given at each stage were sufficient, and the four bidders who gave their views to the National Audit Office said that the bidding timetable was reasonable.

**2.26** The Department met bidders in the first round to clarify any uncertainties about the sale, and the four bidders shortlisted for the second round were given access to a 'data room' containing specific details of all sites, and visits to a selection of sites. The four final bidders told the National Audit Office that they were generally given adequate information, although one suggested that provision of some additional basic information could have had a positive effect on the bid they were able to make, and another that the Department could have issued certificates of title to reassure bidders, with the cost passed to the winning bidder.

**2.27** The Department's advisers, Herbert Smith, noted however that such a large property sale inevitably involved risk concerning the precise details and condition of the estate. The Department sought to transfer this risk to the bidders, putting the onus on them to undertake their own investigations and to satisfy themselves about property title and other details of the sites to be purchased. Herbert Smith considered that providing title certificates would have significantly increased the Department's legal costs, whilst not being likely to improve the sale price or substantially to reduce bidders' workloads. Nevertheless, the Department provided warranties in the sale, limited to £50 million, to meet any major costs incurred by the new owners arising from any unexpected difficulties in establishing title to the properties that might result from inaccurate or deficient information from the Department. Claims are only possible for £10 million or more and any claims must be made within two years of the sale.

### **The evaluation of bids**

**2.28** The Department developed criteria to evaluate bids during the bidding rounds:

- a) For pre-qualification applicants, the Department and their advisers (NatWest Markets) reviewed bidders' financial resources, property management experience and their financial probity and commercial reliability.
- b) Before receiving first round bids, NatWest Markets developed criteria against which the Department evaluated and scored different aspects of the bids received in the first and subsequent bidding rounds (Box 4).

#### The Department's criteria for evaluating bids

##### **Box 4**

- i) **price**, taking account of wider factors affecting value offered, such as any tax avoidance structures or hidden costs;
- ii) **finance and deliverability**, including identification, availability and reliability of sources of finance; complexity of consortia, and whether formally established; ability to complete the deal within the timetable envisaged; and consortia members' commitment to the transaction;
- iii) **acceptance of the sale terms and procedures** - a readiness to complete the deal on the terms specified by the Department; and
- iv) **likely long-term relationship with the Department**, including the quality of the management team, commitment to long-term ownership of the estate and understanding of, and respect for, Service needs and sensitivities.

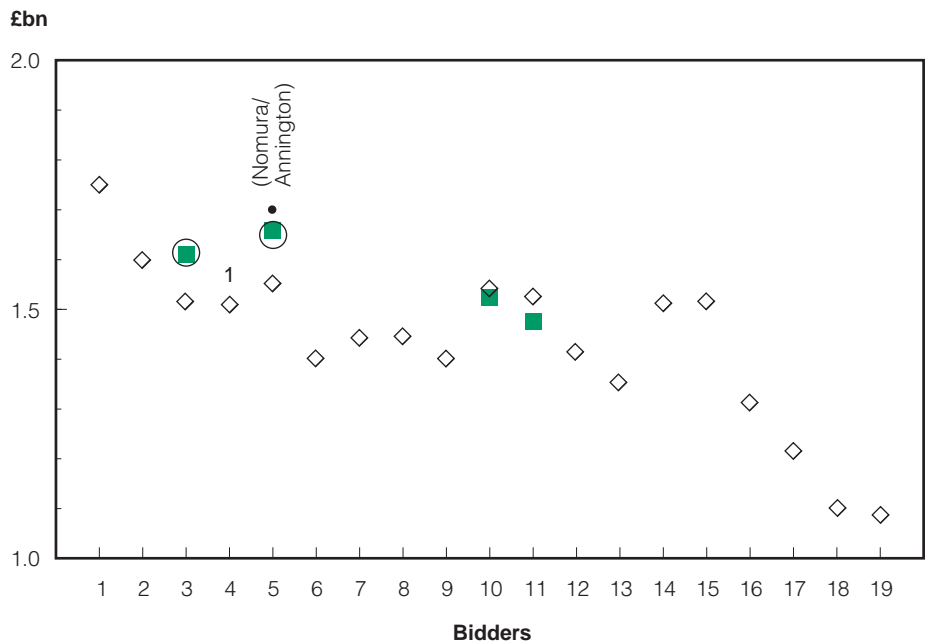
Items ii, iii and iv were divided into a total of ten separate sub-criteria.

**2.29** Figure 7 shows the prices offered at successive rounds of bidding. The 19 **first round bids** varied from £1,100 million to £1,750 million. The National Audit Office examined the Department's evaluation of the bids, and confirmed that the Department, together with their main financial advisers (NatWest Markets), had scored bids against each of the evaluation criteria in Box 4. The Department

held clarification meetings with bidders to discuss any perceived weaknesses in individual bids, after which bidders were asked to confirm their bids. One bidder withdrew, and as a result of their evaluation the Department made a selection of four of the remaining bidders, with Ministers' approval, to proceed to the second round of bidding. They decided not to pursue further the two bids which were higher, on the basis of the NatWest Markets' assessment of these bids against, in particular, the finance and deliverability criteria.

**Bid prices received by the Department**

**Figure 7**



First round:	Second round:	Best and Final Offer round:	Sale price:
◇	■	○	●
Confirmed bids (15/5/96)	(31/7/96)	(23/8/96)	(24/9/96)

Note 1. Withdrew from first round, without confirming this bid.

Source: National Audit Office analysis of Ministry of Defence papers

Figure 7 shows the prices included in bids in the first, second and final rounds of bidding for each of the 19 consortia submitting bids in the first round.

**2.30** The Department applied the same evaluation criteria to the four **second round bids** that they had applied in the first round, and this produced a clear winner, Annington, on both price (Figure 7) and qualitative grounds. On the recommendation of NatWest Markets, the Department introduced the previously unplanned **'best and final offer'** round (Figure 7), to maintain competitive tension



while detailed offer conditions were being clarified and negotiated. They gave Annington and the next best bidder a week to reconsider and improve their second round offers.

**2.31** Both bidders made improvements on the conditions of their second round bids, although Annington offered £8 million less than in the second round, broadly reflecting subsequent reductions in the number of quarters covered by the sale. The other bidder made no price adjustment for these reductions. The Department also received an unsolicited further bid from one of the other second round consortia, which was between the other two responses on price. Annington still offered the highest price and was judged by the Department and their advisers, NatWest Markets, as best meeting their qualitative criteria, and on 3 September the Department notified them that they were the preferred bidders. Following final negotiations to resolve outstanding details, primarily concerning the clawback arrangements (paragraph 4.9) and documentation on the properties and the utilities arrangements, contracts were exchanged on 24 September 1996.

**2.32** The Department completed the sale seven weeks later than they envisaged when they issued the Information Memorandum in February 1996, and over five months later than NatWest Markets' outline timetable drawn up in July 1995. This partly reflected the extension of the first round of bidding, to seek revised indicative offers from the 19 companies and consortia who expressed interest at that stage, and the introduction of a 'best and final offer' round.

**2.33** The Department offered to debrief each of the three losing bidders on the outcome of their particular bid, and two bidders took up the offer. In their comments to the National Audit Office, the final four bidders highlighted the tension between providing an adequate degree of competition while giving bidders sufficient chance of winning to justify the cost of bidding. Two bidders considered that bidders' costs were high, and might have been reduced by more tasks being undertaken by the Department (paragraph 2.26) or shared by bidders, and by having smaller final shortlists, although another bidder thought that a final shortlist of four provided an appropriate balance.

## **Main points**

**2.34** The main points are:

- a) The Department used consultants to generate, measure and maintain significant interest in the market for the sale, and were able to add further bidding rounds to those planned at the outset to maintain competitive tension.

- b) The Department developed evaluation criteria, against which they and their advisers scored bids subsequently received. The Department decided not to pursue the two highest price bids in the first round of bidding on the basis of their advisers' assessment against, in particular, finance and deliverability criteria. As a result of the second and closing stages of bidding, the Department chose the bid which best met their evaluation criteria, and offered the highest price.

## **What were the arrangements for payment?**

**2.35** The £1,662 million purchase price was payable in two instalments: £962 million on completion (less the first rent payment due), and £700 million deferred to 1 April 1997. This two-tranche payment was at the request of the Treasury, to suit the requirements of wider national finances for 1997-98. The Department considered that splitting the payment would help bidders to arrange their finance and would be taken into account in the level of their best and final offers, provided that bidders had sufficient time to arrange a revised financial package and that competitive tension was maintained.

**2.36** The Department notified the four second-round bidders of the proposed payment arrangements five weeks before bids were to be submitted, and the bidders told the National Audit Office that this was sufficient time for them to take account of the deferred payment requirement. If the sale price reflected fully the benefits to the purchaser of the deferral there was no loss to the Exchequer, and possibly a gain; if it did not, the loss of interest to the Exchequer could have been up to £27 million. The National Audit Office noted, however, that the Department did not establish the extent to which the deferral was reflected in the prices offered. To do so would have involved inviting alternative bids on a single payment basis, but the Treasury's request precluded such an approach.

**2.37** To provide security for the deferred payment, the Department required the purchaser to obtain a 'letter of credit' from a bank of sufficient credit-rating itself. In the event of the purchaser defaulting on the second payment, the bank would be legally liable for the payment to the Department. The purchaser would pay for obtaining the letter of credit. In completing the sale the Annington Group obtained a letter of credit, drawn on Abbey National Treasury Services (one of the financial backers in the Annington consortium - paragraph 1.1), for the full amount of the deferred payment. The deferred payment was made in full and on time on 1 April 1997.

## Main points

**2.38** The main points are:

- a) At the request of the Treasury, the sale price was payable in two instalments. This was notified to the bidders five weeks before bids were to be submitted. If the sale price fully reflected the benefits of the deferral of the second payment, there was no loss to the Exchequer, and possibly a gain - if not, the loss could have been up to £27 million. The Department did not establish the extent to which the deferral was reflected in the prices offered - the Treasury's request precluded a dual bid approach that would have established this.
- b) The Department secured the deferred payment, paid on 1 April 1997, by requiring the winning bidder to obtain a letter of credit with a highly credit-rated bank.

## What were the costs of the sale?

**2.39** When the Housing Trust scheme was abandoned, the Department had spent £7.6 million of their £9 million budget for setting it up. They had also incurred expenditure on setting up and winding down the embryo Housing Trust organisation, including £375,000 to three individuals appointed to the Housing Trust (two of whom received compensation). Work done to establish property title was utilised in the subsequent sale, however, and the Department consider that work on the Housing Trust proposals helped to refine their thinking and approach to the later property sale and the structure of the Defence Housing Executive. In October 1995, the Department established a further budget of £15 million for the proposed sale, against which the Department spent some £12.6 million (Figure 8) - less than one per cent of the sale price, or a little over one per cent if the costs of the Housing Trust are taken into account.

**The costs of the sale and the Housing Trust proposals, compared with budget**

**Figure 8**

*The costs of the sale*

	<b>Costs<sup>3</sup></b>	<b>Budgets</b>	<b>Variance</b>
	<b>£m</b>	<b>£m</b>	<b>£m</b>
External costs <sup>1</sup>	11.1	13.6	(2.5)
Internal costs	1.5	1.4	0.1
	12.6m	15.0m	(2.4m)

*The costs of the Housing Trust scheme*

External costs	5.2	-	-
Internal costs <sup>2</sup>	2.4	-	-
	7.6m	9.0m	(1.4m)

**Totals** **20.5m** **24.0m** **(3.5m)**

- Notes: 1. Includes local authority and Land Registry fees.
2. The Housing Trust 'internal costs' include £375,000 in respect of terminal, compensation and bonus payments to individuals following the winding up of the Trust scheme.
3. All costs are VAT exclusive, as VAT is refundable on contracted-out services such as legal advice and other professional services.

Figure 8 shows the costs and budgets for the Housing Trust and subsequent sale of the married quarters estate. The costs remained within budgets and represented about one per cent of the sale price achieved.

Source: Ministry of Defence

**Main points**

**2.40** The Department set budgets for developing proposals for the Housing Trust, and, subsequently, for the sale of the married quarters. They spent £20.5 million in all including £12.6 million on the sale (£2.4 million less than budgeted). The costs of the sale itself represented less than one per cent of the sale price.

## Part 3: How the Department decided whether to proceed with the sale

**3.1** This Part looks at the evaluative work carried out by the Department in deciding whether to sell the married quarters estate. One of the Department's pre-conditions for the sale was that the price should 'reflect the public interest'. This depended on securing the best price available in the market (Part 2), and on the net benefits of proceeding with the sale. For this purpose, the Department identified the two main benchmarks below.

### The benchmarks used by the Department, and examined in this Part

- a comparison of the sale price with valuations of the estate; and
- a comparison of the financial implications of the sale with continued in-house ownership of the quarters by the Department.

### How did the sale price compare with valuations of the estate?

**3.2** In February 1996, the Department's main property advisers, Savills, assessed the value of the estate at £1,820 million, as a broad cross-check on the emerging results of the Department's investment appraisal (paragraph 3.5). Their valuations were based on the value of individual site disposals (rather than a bulk disposal), and on vacant possession, to allow the Department to set baselines for calculating clawback receipts. Under the sale, however, the Department intended to remain in occupation of the bulk of the estate for many years, and the Department recognised that what would determine the sale price was not so much the valuation of the assets, as the opportunities for revenue generation for the new owners - from rents, redevelopments and disposals. To help them test the reasonableness of bids actually received, the Department obtained estimates of the possible value that might be placed on the sale by prospective purchasers:

- a) Savills considered the broad circumstances of the sale, and their assessment did not constitute a valuation of the estate in accordance with normal Royal Institution of Chartered Surveyors practice. Depending on bidders' likely assumptions about the rate of surrender of surplus quarters by the Department, however, and whether these would be mainly high or low value quarters, Savills assessed the value of the purchase to be between £1,305

million and £1,625 million, and averaging £1,500 million (the actual sale price was £162 million higher than this average). They considered this figure could be further discounted, by up to 10 per cent (to £1,350 million), to reflect problems bidders might face in financing such a large bulk purchase.

- b) From an illustrative model for the likely cash flows under the sale for prospective new owners, NatWest Markets estimated that these might be worth about £1,480 million to a new owner (the actual sale price was £182 million more).

**3.3** Treasury guidance on disposals recommends the independent valuation of properties to be sold, and using the results to set a target price to be achieved. Because in selling the married quarters estate its value would be influenced by the characteristics of the sale package and bidders' likely cash flows, the Department used the results of an investment appraisal (described in paragraphs 3.5 to 3.14 below) to derive a benchmark price.

### Main points

**3.4** As the sale price would be determined by opportunities for revenue generation by new owners of the married quarters, the Department assessed the possible values that prospective new owners might place on the sale. The Department's advisers considered that, depending on assumptions about the surrender of surplus quarters by the Department, the estate was worth about £1,500 million, or £1,350 million after allowing for the scale of the financial transaction involved (the sale price achieved was £162 million and £312 million higher respectively); and the likely cash flows under the sale to be worth £1,480 million to a new owner (the sale price was £182 million more).

## How did the financial implications of the sale compare with the Department retaining ownership?

**3.5** The Department sought to compare the financial implications of the sale with those of retaining ownership of the quarters and managing them in-house. Their aim was to identify a sale price that would match both the future opportunities for income from selling surpluses that would be lost from proceeding with the bulk sale, and the rents and other outlays involved under the sale (Figure 9).

**Basis for calculating the sale price needed to match the financial consequences of not proceeding with the sale**

**Figure 9**

The 'present value'<sup>1</sup> to the Department of the net proceeds from the Department continuing to identify and sell their surplus quarters themselves.

+

The 'present value'<sup>1</sup> to the Department of the net rent and other payments under the sale.

=

**The minimum sale price needed to match the 'present value'<sup>1</sup> to the Department of not proceeding with the sale.**

Note 1. Sums paid or received now are worth more than the same amounts arising at a future date. Accordingly, future sums are discounted to their equivalent 'present value' using a rate that represents how quickly time erodes the value of these sums.

**3.6** In considering what their financial position would be if they retained ownership and management of the married quarters estate, the Department formulated seven scenarios to test the effect of a wide range of assumptions about future performance. Figure 10 shows the assumptions for each of the scenarios, and, for illustrative purposes, the Department's advisers' views on the likely performance of new owners.

**3.7** At the extremes, one of the scenarios represented levels of performance which were considerably better than the Department's past performance (Scenario One - all surplus properties would be released for disposal as they were identified, and sold within a year), and another much worse (Scenario Seven - no disposal of surpluses in the next 25 years). So the Department regarded scenarios Two to Six as the realistic benchmark range of performance. The key variables were the speed at which properties were identified and declared surplus, and the average sale receipts. As far as practicable, the assumptions used were based on past performance, though the Department were constrained to some extent by the absence of historical data.

**3.8** In broad terms, Scenario Two assumed some improvement on past performance in disposing of surpluses and prices reflecting those previously achieved. Scenario Three assumed a slight deterioration in disposing of surpluses and prices similar to those previously achieved. Scenario Four assumed considerable improvement in disposing of surpluses, but was cautious on price. Scenario Six assumed a slight deterioration in disposing of surpluses, and was cautious about price. The Department identified **Scenario Five** as **the main comparator** for assessing the actual sale price. They considered it important to be

**Figure 10**

**In-house ownership and management scenarios**

Assumptions	<i>In-house management scenarios:</i>							Performance assumed for new owners
	1	2	3	4	5	6	7	
<b>a</b> Proportion of new excess properties released for sale (in excess of an empty quarters management margin - paragraph 1.6)	100% each year	50% each year	30% each year	100% each year	<b>50% each year</b>	30% each year	nil	<b>n/a</b>
<b>b</b> Proportion of stock of excess properties, <b>not</b> immediately released for sale, that are reviewed each year and subsequently released for sale	n/a	25% each year	20% each year	n/a	<b>25% each year</b>	20% each year	nil	<b>n/a</b>
<b>c</b> Time to achieve sale	1 year	1 year	2 years	1 year	<b>2 years</b>	2 years	n/a	<b>1 year<sup>1</sup></b>
<b>d</b> Proportion of quarters empty at year-25	10%	13%	20%	10%	<b>16%</b>	20%	49%	<b>n/a</b>
<b>e</b> Average receipt for sales (as % of £30,800 indicative average price - 1996-97 prices - based on past sales by the Department adjusted for discounts on sales to Service personnel)	100%	100%	100%	75%	<b>75%</b>	75%	n/a	<b>109%<sup>1</sup> (£33,700)</b>
<b>f</b> Additional income from selling houses with adjoining estate ("marriage value") (As % of estimated £10m over 10 years)	100%	100%	100%	100%	<b>100%</b>	100%	n/a	<b>nil</b>
<b>g</b> Proportion of stock of excess properties, not immediately released for sale, that are reviewed each year and rented out while awaiting later disposal	n/a	25% each year	5% each year	n/a	<b>25% each year</b>	5% each year	nil	<b>n/a</b>
<b>h</b> Proportion of open market rental (as % of £4,797 p.a. - 1996-97 prices) achieved, after discounting for bulk	n/a	75%	75%	n/a	<b>75%</b>	75%	n/a	<b>80%<sup>1</sup></b>
<b>i</b> Proportion of redevelopment value (£18m over 10 years) achieved	75%	75%	75%	75%	<b>50%</b>	50%	nil	<b>100%<sup>1</sup></b>
<b>j</b> Maintenance costs of empty houses (as % of £784 p.a. spent by MOD - 1996-97 prices)	n/a	100%	100%	n/a	<b>100%</b>	100%	100%	<b>64%<sup>1</sup> (£500)</b>
<b>k</b> Maintenance costs of houses rented out (as % of £1,985 p.a. spent by MOD - 1996-97 prices)	n/a	100%	100%	n/a	<b>100%</b>	100%	n/a	<b>68%<sup>1</sup> (£1,347)</b>

continued...



---

### In-house ownership and management scenarios (continued)

Note 1. These assumptions about management of the estate under the sale were made in order to estimate clawback and tax receipts.

Source: Ministry of Defence

Figure 10 shows the assumptions used by the Department for seven scenarios for future in-house ownership and management of the married quarters estate. **The Department used Scenario 5 as the main comparator for the sale.** The assumptions covered a wide range of performance for future in-house ownership and management of the estate.

---

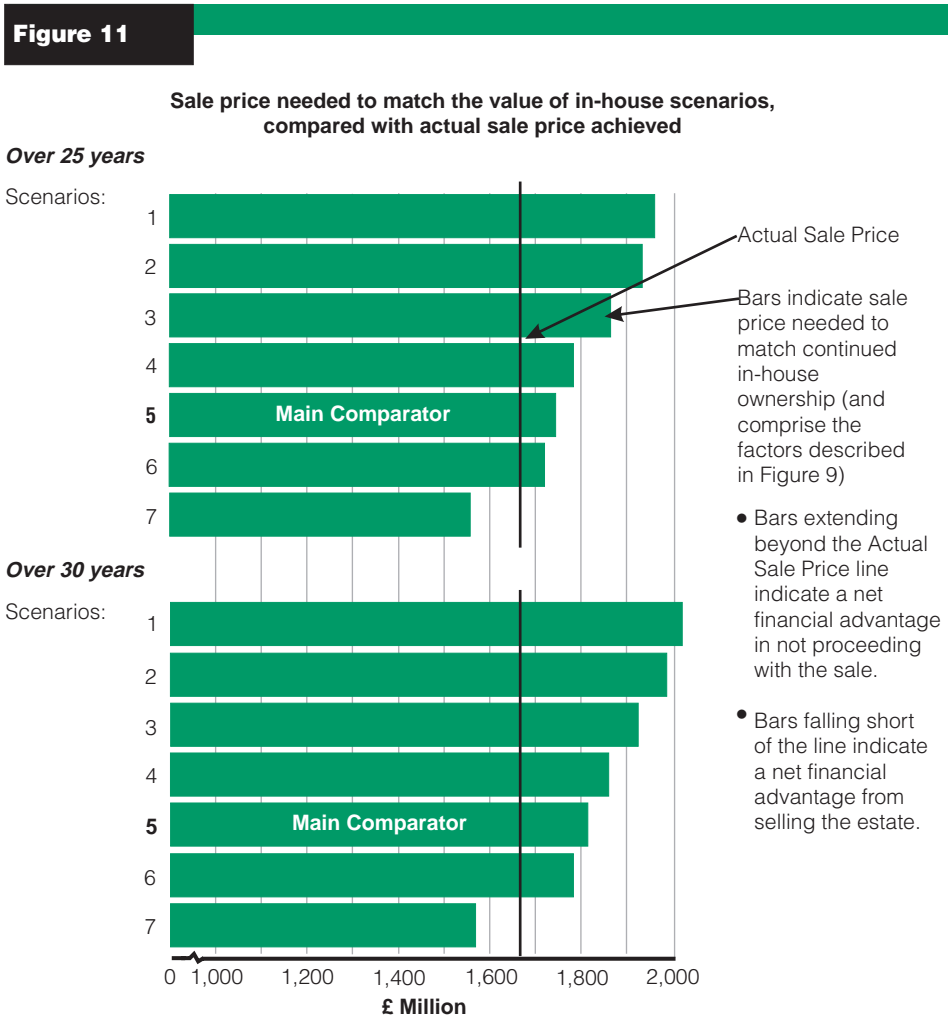
realistic but conservative in their assumptions, and, overall, Scenario Five assumed a slight improvement in disposing of surpluses, and was cautious about price. Specifically, Scenario Five assumed:

- a) that sale prices for surplus houses would be three-quarters of the indicative average price previously achieved by the Department, and two-thirds of the prices the Department expected new private sector owners to achieve (Figure 10, item e).
- b) that a two-year period would be needed to achieve sales, compared with one year for two of the other scenarios and for new private sector owners (Figure 10, item c);
- c) that the Department would secure half as much development gain from surplus sites as new private sector owners might achieve (the Department's property advisers, Savills, estimated this overall potential development gain to be worth £18 million over 10 years). Under four other scenarios, the Department assumed that they would receive three-quarters of the development potential (Figure 10, item i); and
- d) that maintenance costs for empty properties and those rented out to third parties would be half as much again as those that the private sector would incur (Figure 10, items j and k). The difference, over 25 years, was worth £6 million in present value terms.

**3.9** The net present values of the seven scenarios are detailed in Figure A of Appendix 5, and summarised in Figure 11. Using a 25 year period for the investment appraisal shows that a sale price of £1,712 million to £1,926 million was needed to match the present values of Scenarios Two to Six, with £1,739 million needed to match the present value of Scenario Five - £77 million more than the actual sale price. The Department extended the investment appraisal period to 30 years to take account of possible changes in the numbers of

quarters leased, and the level of rents and other payments, after the first 25 year breakpoint in the leases. This produced a value of £1,801 million for Scenario Five, £139 million more than the sale price achieved.

Investment appraisal summary data for in-house scenarios 1 to 7, over 25 and 30 years



Source: National Audit Office analysis of Ministry of Defence investment appraisal

Figure 11 shows how the value of the Department's seven in-house management scenarios, described in Figure 10, compare with the sale price subsequently achieved. Scenario 5, the Department's main comparator, was worth more than the price achieved, and only under Scenario 7 would the sale price clearly improve the financial position of the Department.

**3.10** For the purposes of their investment appraisal, the Department assumed that market property and rent levels would rise by one per cent above inflation in the long term, and that their occupancy of the married quarters would fall steadily from 55,000 to 30,000 over the next 25 years. For the first 25 years there are effectively lower limits on the number of quarters the

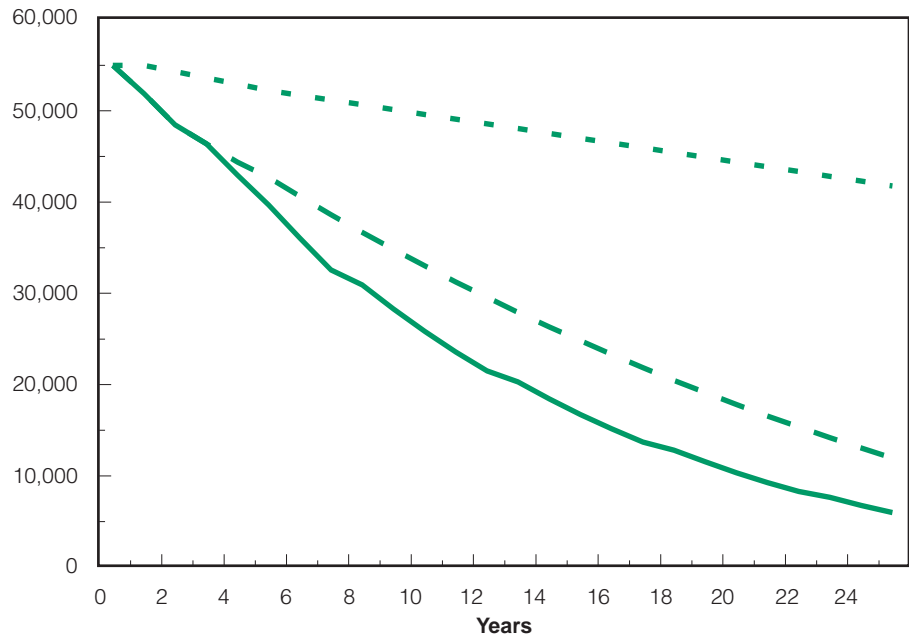
Department will lease back, derived from the guaranteed payment provisions, and upper limits because the Department must surrender a minimum number set for each anniversary of the sale.

**3.11** The Department built these minima and maxima for the first 25 years (Figure 12) into the sale package to reduce uncertainty for the prospective new owners, and thereby help avoid unnecessary reductions in bids offered (as Box 2 shows, rents were discounted by 10 per cent to reflect the benefits to prospective new owners from the guaranteed minimum payment). The Department did not have detailed plans regarding the level of married quarters occupancy beyond 1999, when their current programme of manpower reductions would have been completed, but they informed the National Audit Office that they had set the minima and maxima at levels that they considered would be very unlikely to be breached.

**Implied occupancy of married quarters by the Department, over the first 25 years**

**Figure 12**

Number of quarters



- - - Implied by the Guaranteed Surrender of surplus quarters  
- - - Implied by Guaranteed Payments, assuming rents rise in line with an assumed 2 per cent general inflation  
— Implied by Guaranteed Payments, assuming a 1% real growth in rents (Figure 13)

Source: Ministry of Defence

Figure 12 shows the number of married quarters to be leased back by the Department, implied by the guaranteed surrender provisions of the sale and by the minimum payment arrangements.

**3.12** The Department recognised that future property values and the number of married quarters they would need would affect the value for money of the sale. For example, if property values rose the new owners rather than the Department would realise the benefits, and the Department would benefit from lower total rent payments if they required fewer married quarters. The Department noted too that they might not be able to retain all of the married quarters that they wished to keep after 25 years, when, subject to the Department's right of veto on operational grounds, the new owners would have the right to terminate the Department's underleases, and that providing alternative accommodation might involve additional cost.

**3.13** The Department therefore built into their investment appraisal sensitivity analyses reflecting a range of assumptions about the occupancy of married quarters, market values and the extra cost of providing accommodation should the new owners terminate leases after 25 years (Figure 13). Figure B of Appendix 5 summarises the financial consequences for the main comparator of these alternative assumptions, and Figure 14 on page 42 shows how these compared with the sale price achieved.

**3.14** The Department's analysis, shown in Figure 14, indicated that for the main comparator the sale price would only exceed the value of continued in-house management if:

- growth in real property values remained low. The National Audit Office calculated that real property values would have to grow by no more than about 0.2 per cent to 0.5 per cent for the sale price to exceed the value of continued in-house ownership of the estate; or
- the Department's requirement for married quarters (and resulting rent payments) fell more quickly than anticipated. The National Audit Office calculated that the number leased would have to fall from the current figure of 55,000 to about 21,000 quarters after 25 years.

**Assumptions for sensitivity analyses in the Department's investment appraisal, used in Figure 14 and Appendix 5 (Figure B)**

**Figure 13**

<i>Sensitivity</i>	<i>Assumptions</i>
A The Base Case	Includes 1% annual real growth in property prices and rents; and the Department's current occupancy of 55,000 quarters falling to 31,000 quarters by year 25.
B High Property Market Growth	2% annual real growth in property prices and rents.
C Low property market growth	Static (0%) annual real growth in property prices and rents.
D Property rental collapse	1% annual real growth, except for a 25% real fall in 2001-02 and no growth between 2002-03 and 2004-05.
E Very high MoD occupancy	Falling to 50,000 at year 25 (and year 30). Would involve accounting for minimum surrender provisions by renting extra quarters in the market.
F High MoD occupancy	Falling to 45,000 at year 25 (and 44,000 in year 30).
G Low MoD occupancy	Falling to 15,000 at year 25 (and 6,000 in year 30).
H Very low MoD occupancy	Falling to zero quarters by year 25, triggering the guaranteed minimum payment provisions.
I Leases terminated at 25 years	The Base Case, above, but with additional costs arising from five per cent of leases being terminated at 25 years.

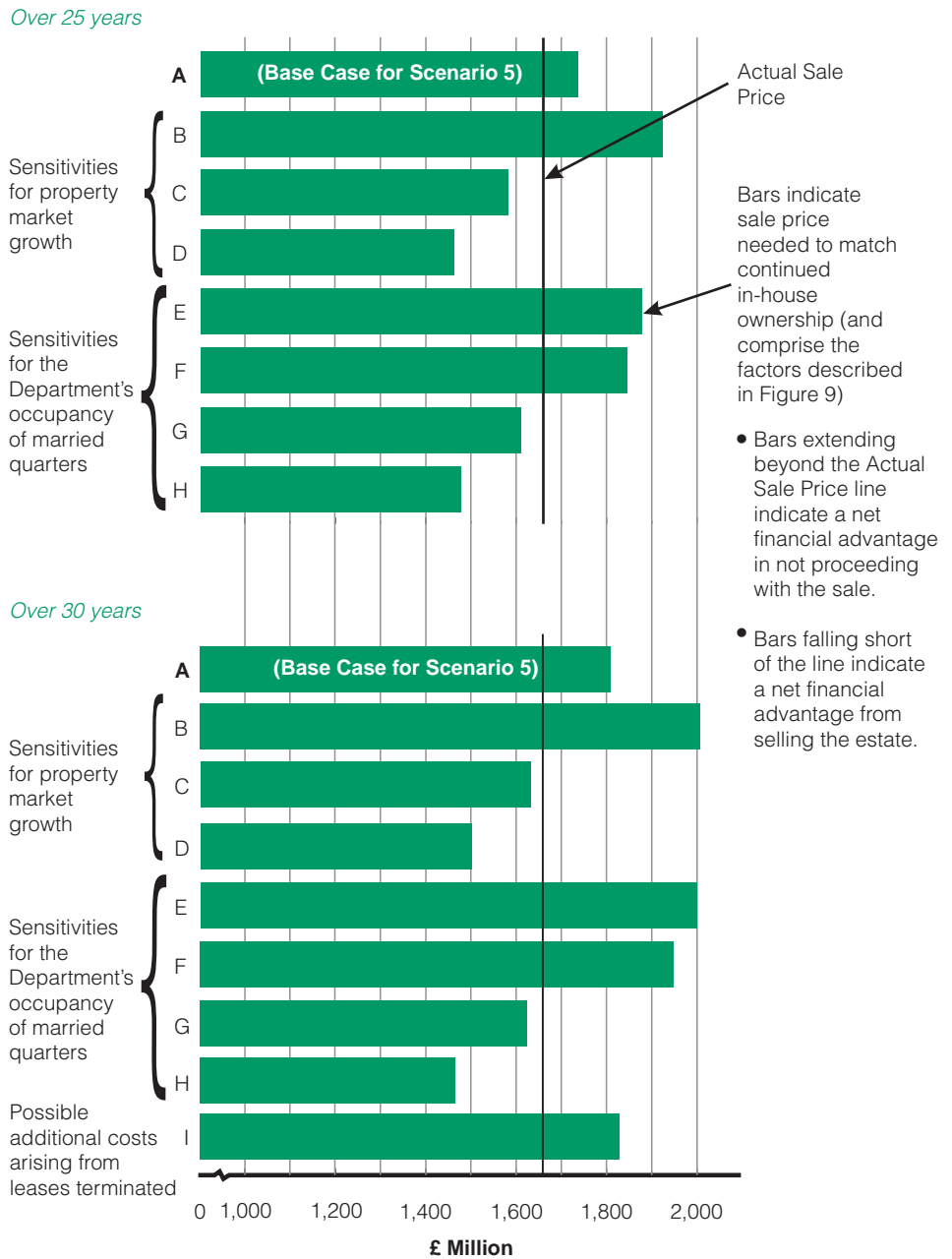
Figure 13 shows the assumptions for the sensitivity analyses used in the Department's investment appraisal. The Department expected rents to rise by one per cent in real terms and their use of the quarters to fall by about half (the Base Case), but their sensitivity assumptions ranged from two per cent real growth in rents to a property market collapse, and use of quarters to fall by between 10 and 100 per cent.

Source: Ministry of Defence

**Sensitivity analysis for the 'base case' (Scenario 5), over 25 and 30 years**

**Figure 14**

**Sale price needed, compared with actual sale price**



Source: National Audit Office analysis of Ministry of Defence investment appraisal

Figure 14 shows that the value of Scenario 5 (Figure 10) for in-house ownership of the married quarters was more than the sale price achieved. Figure 14 also shows how the values for the sensitivity analysis assumptions for Scenario 5, detailed in Figure 13, compare with the sale price achieved.

## Main points

**3.15** The main points are:

- a) The Department compared the sale price with the financial consequences of continued in-house ownership and management of the married quarters.
- b) Using the Department's main comparator, the sale price achieved was £77 million to £139 million less than the assessed value of continued Departmental ownership and management.
- c) The Department tested the sensitivity of their investment appraisal, taking account of possible future rent levels and the number of quarters to be leased by the Department. This indicated that the purchase price achieved was higher than the value of continued in-house ownership and management, only if growth in real property values remained low or the number of quarters leased fell from the current figure of 55,000 to about 21,000 over the next 25 years.

## What risks are transferred to the new owner, and which are retained by the Department?

**3.16** The Department's assessment of whether to proceed with the sale did not depend exclusively on how the sale price compared with the value of continued in-house ownership and management of the married quarters estate, or how it compared with the value of the properties concerned. Also important was the balance of the risks (that is, uncertainty about future gains and exposure to loss) between the Department on the one hand and the new owners on the other.

**3.17** The National Audit Office examined the extent to which risks had been transferred to the new owners, or retained by the Department. In doing so, they had regard to Statement of Standard Accounting Practice 21, concerning the accounting treatment of leases, and Financial Reporting Standard 5, dealing with the substance of financial transactions, issued by the Accounting Standards Board. Where insufficient risk lies with the lessor, the Treasury consider that such leases may not represent good value for money in the public sector, because they might involve a form of Government borrowing that is more expensive than borrowing through the issue of gilt-edged securities.

**3.18** To guide overall judgements about the extent of risk transfer, the accounting standards highlight the importance of which party in practice has access to future economic benefits and is exposed to possible losses (that is, the risks and rewards of asset ownership), rather than considering which party has strict legal title. The standards set out a range of guidelines and assessment criteria:

- a) qualitative factors;
- b) a numeric rule-of-thumb; and
- c) the rate of return for the lessor.

**(a) Qualitative criteria**

**3.19** Assessing where the balance of ownership risks lie, between lessor and lessee, depends on a rounded consideration of all the circumstances of the lease. However, the accounting standards identify a range of qualitative factors, as a guide, and the National Audit Office assessed the married quarters sale against these (Figure 15). Some factors pointed to risks remaining with the Department - the longevity of the lease and the minimum payment provisions. The Department also remain responsible for maintaining the quarters, and bear the risks associated with the maintenance required and its cost. The overall results, however, indicated that in most respects ownership risks have transferred to the new owners (Figure 15). This was in line with the Department's analysis that the new owners would bear the risks and rewards associated with the release of surplus quarters from the Department and with the future value of the estate. The Department would have greater flexibility in managing their housing needs by renting rather than owning houses, but they would have to bear the consequences of any volatility in the rented housing market.



**Figure 15****Application to the sale of qualitative criteria to help judgements about the classification of leases**

<i>Criteria<sup>1</sup></i>	<i>Application of the criteria to the sale</i>
a) Whether the sale price reflected the market value of the assets (if the price differs from the assets' market value, it suggests that not all risks and potential rewards have been placed with the lessee).	The sale price was set by competition in the market, although it subsumed the benefits to the new owners of the provisions for minimum surrender of quarters and the Guaranteed Payments (paragraphs 2.8 and 3.10).
b) Whether lease rents are based on market rents, or on rates for use of funds.	Rents are based on market rents, suggesting risks and rewards lying with the new owners. They cannot fall, however, below the initial rent level (paragraph 4.4).
c) The nature of the lessors' (Annington's) business; whether a financing company or an asset leasing company.	Annington are a newly created group of companies, without a track record in either finance or asset management. One of the consortium members, however, have expertise in property management; the other members are finance companies.
d) Whether there are options for the assets to be bought by the lessee (the Department) at the end of the lease.	The Department do not have the option to buy back the married quarters in the future, suggesting risks and rewards lying with the new owners.
e) Which party carries the risk of a fall in value of the leased asset, and which benefits from any appreciation. And which party retains the receipts from any sale of the assets to third parties.	Annington carry the risk of a fall in value of the quarters and benefit from any appreciation, although the Department have a clawback on a share of such gains (paragraph 4.9).
f) Whether the lessee has the freedom to use the assets as they see fit.	The Department may use the quarters as they choose, including use for non-residential purposes, suggesting rewards of ownership lying with the Department. Quarters surrendered by the Department, however, have to be in 'tenantable condition'.
g) Whether the lessee has the use of the assets for their likely useful economic life.	The Department have the use of the 'retained' quarters for at least 25 years, and have protection against Annington's ability to terminate the 200-year underleases, including financial compensation and a four year notice period (paragraph 4.13), suggesting rewards of ownership lying with the Department.

continued...

---

**Application to the sale of qualitative criteria to help judgements about the classification of leases (continued)**

<i>Criteria<sup>1</sup></i>	<i>Application of the criteria to the sale</i>
h) Whether, on cancellation of the lease, the lessee bears any losses associated with the cancellation.	If the underleases were terminated, the Department's rent payments would cease, suggesting risks of ownership lying with the new owners, although the Guaranteed Payments continuing for 25 years suggests risks of ownership lying with the Department
i) Whether the assets are of a specialised nature, so that only the lessee or a limited number of other parties can use them without major modification.	A fifth of quarters are 'behind the wire', needing access improvements before they could be made available for other customers. The remainder can be sold-on or let to other customers once surrendered by the Department, even without redevelopment, suggesting risks and rewards lying with the new owners for most of the quarters.

Note 1. From Institute of Chartered Accountants of England and Wales' Technical Release 664 (1987), "FRAG 9/92" (1992) on the implementation of Statement of Standard Accounting Practice 21, and Financial Reporting Standard 5 (1994).

Source: National Audit Office analysis against criteria identified in accountancy standards listed in Note 1 above .

Figure 15 shows how the characteristics of the sale relate to the qualitative criteria for classifying leases. Most criteria indicate risks lying with the new owners, but there are some areas which would usually suggest risk lying with the lessee (the Department) - the the long length of the lease and the guaranteed payments which the Department would have to pay if they surrendered all quarters (effectively terminating the lease).

---

**(b) The numeric rule of thumb**

**3.20** Where the present value of the minimum lease payments amounts to 90 per cent or more of the fair value of the assets, Statement of Standard Accounting Practice 21 presumes that the leased assets would appear on the lessee's balance sheet, because insufficient risk lies with the lessor. And as paragraph 3.17 noted, the Treasury consider that such cases may not represent good value for money.

**3.21** For the sale of the married quarters estate, the Department's accounting advisers (Price Waterhouse) concluded that, depending on the assumptions used, the guaranteed minimum payments would represent between 38 and 74 per cent of a sale price of £1,400 million to £1,800 million, estimated at that time. The National Audit Office confirmed that on the actual sale price of £1,662 million, the minimum rents (worth about £930 million in real terms over 25 years, in present value terms) fell below the 90 per cent threshold. Depending on the assumptions used, they were between 57 and 67 per cent of the sale price.

**3.22** Where there is an effective choice, the 10 per cent discount in the rents paid by the Department gives them an incentive to meet all of their married quarters requirements by renting from Annington rather than from another landlord. The National Audit Office therefore examined what effect a higher level of total rents would have. They estimated that, on the basis of the £1,662 million sale price, anticipated rents would have to be £1,471 million over 25 years (in present value terms) to breach the 90 per cent threshold. This compares with the rent of £1,325 million (present value) implied by the number of leased quarters in the 'base case' used for the Department's investment appraisal (paragraph 3.10).

### **(c) The rate of return**

**3.23** Financial Reporting Standard 5 states that in determining the accounting treatment of leases, greatest weight should be given to those aspects of the lease which in practice are most likely to have commercial effect, and that it is important to consider the motives of the parties involved. In particular, it concludes that a lessee might need to record a leased asset on its balance sheet if the lessor receives a lender's rate of return, and no more, as this indicates that insufficient risk rests with the lessor.

**3.24** Only the new owners (the lessor) can determine the likely rate of return on their purchase price - it would depend on their view, amongst other things, of development potential for the estate. The National Audit Office estimated, however, the return that might be possible in broad outline terms. They took account of the level of rents from the Department, assumed in the Department's investment appraisal 'base case'; the rents that new owners might get from other tenants for those quarters surrendered by the Department (assuming that these would be similar to those previously obtained from the Department, though without the 10 per cent discount for the minimum payment provisions - Box 2); and the Department's assessment of the residual value of the quarters at the end of 25 years.

**3.25** On this basis, the National Audit Office's assessment, which they discussed and agreed with the Department, was that apart from potential gains from redeveloping sites surrendered by the Department, the purchase price of £1,662 million implied a real rate of return of 7.5 per cent. This compared with, for example, returns of less than four per cent generally available from long-dated index-linked gilts which are risk-free, indicating that Annington's bid included an element for risk.

**3.26** A further indicator of risk borne by the new owners is whether the purchase was financed by risk capital - if there were significant risks, lenders would not want to provide all of the finance required because this might jeopardise the security of their loans. In the context of the sale of the married quarters, Annington told the National Audit Office that they had raised £1,503 million for the purchase from loans secured on Annington's assets (including £903 million secured on the guaranteed payments due from the Department), and risk capital of £289 million. Risk capital comprised a £75 million Note Issue credit facility; £204 million of unsecured 'subordinated debt' (whose principal would only be paid after that due on the secured loans, and whose interest would only be paid if sufficient funds were available after interest had been paid on the secured loans and any of the credit facility taken-up); and £10 million of 'warrants' which may be later converted into shares. The Group's £289 million risk capital represented 17 per cent of the funds needed to buy the married quarters.

### **Main points**

**3.27** The main points are:

- a) On the basis of qualitative criteria for assessing the balance of risk, in most respects the characteristics of the sale point to risk being transferred to the new owners, although some factors pointed to risks remaining with the Department who would also remain responsible for maintenance. The new owners bear the risks associated with the release of surplus quarters by the Department and with the future value of the estate. Because of the rents payable under the sale, the Department will bear the consequences of any volatility in market rents.
- b) The sale transfers sufficient risk to the new owners to satisfy the indicative numeric test for the accounting treatment, and likely value for money, of leases.
- c) National Audit Office analysis indicated that the new owners were likely to secure a rate of return in excess of that available from risk-free Government securities, and the new owners told the National Audit Office that a sixth of the funds needed for the purchase comprised risk capital.

## **What was the Department's overall assessment on proceeding with the sale?**

**3.28** The Department and Ministers recognised that the purchase price was lower than the benchmark value attached to continued Departmental ownership and management of the married quarters estate. Although there would be transfer of risk to the new owners, the sensitivity analyses in the investment appraisal effectively allowed for this. Ministers decided to proceed with the sale, and accept the 1,662 million bid as a price which properly reflected the public interest, on the basis that:

- a) the ownership of property did not form a core element of Defence business and the sale offered the opportunity to release from public ownership this large residential portfolio, and thereby the risks associated with its ownership;
- b) the new owners would be better placed to manage the properties which fall surplus, and release them for use by others;
- c) the sale would release funds for the upgrade programme at a rate which could not otherwise be achieved, and was the only way in which the necessary upgrade of the estate could be achieved in the short-term;
- d) the possibility of downstream opportunities and efficiencies from partnership with the new owner (the Department had identified, for example, the possibility of economies from moving towards joint maintenance of the quarters leased by the Department and of those surrendered to Annington);
- e) the understanding of, and sensitivity to, the Services' concerns about the management of the estate which Annington had shown; and
- f) the Department's assessment that, within the sale option, the price was the best which a good competition could extract from the market.

## Part 4: How the Department have protected their future interests

**4.1** The value for money of the sale depends not just on what was included in the sale and the price achieved, but also on what happens in the future. The National Audit Office examined the following aspects which may have a critical impact on the overall value of the sale:

### Aspects examined in this Part

- the way rent reviews are conducted
- the arrangements for the Department to share in the benefits of any gains by the new owners
- how the Department will be affected if underleases are terminated.

### How will rent reviews be conducted?

**4.2** Under the sale, the leases provide for rent review at five year intervals. The reviews will reassess Assured Shorthold Tenancy rents on the open market, less the 58 per cent discount (paragraph 2.7). The rent will be negotiated between the Department and the new owners on the basis of valuations conducted by each side, and there are arbitration procedures defined in the sale contract. The reviews will focus on rents for a representative 'beacon' house selected by the Department's advisers for each underlease site, with any resulting rent adjustment applied to all properties on that site. The sale contract defines the initial value and condition of the beacon houses, and in reassessing rents any improvements to the properties by the Department will be excluded.

**4.3** In the first round of bidding for the sale, several bidders had suggested indexing the rent payments annually to the Retail Prices Index. The Department calculated that this might reduce their rent bill by some £54 million in present value terms over 25 years, because their assumption was that rents would rise by one per cent above inflation in the long term (paragraph 3.10). They decided, however, to retain five-yearly open-market valuations because the bidders would have been likely to reduce their offers by a similar amount, and because the Department wanted to keep rents broadly in line with market rent levels.

**4.4** During the sale, the Department also examined the advantages and disadvantages of setting an ‘upward-only’ rent review regime, to make the sale package as attractive as possible. Their financial advisers, NatWest Markets, estimated that it could have been worth up to £150 million to prospective purchasers, which would have been reflected in higher sale prices offered. However, this was not included in the sale package because of wider Government initiatives to move the property market away from automatic inclusion of such inflationary clauses. In its place, however, reviewed rents will be underpinned by the original rent over the first 25 years - that is, rent for a particular site may go up or down, but cannot fall below the *initial* underlease rents paid.

### Main points

**4.5** The main points are:

- a) Under the sale, the Department’s rents will be reviewed in a rolling five-yearly programme. These will be negotiated, based on valuations by the Department and the new owners respectively.
- b) Over the first 25 years, rents for individual sites may go up or down, but they cannot fall below those initially set.

## Are there arrangements for the Department to share the benefits of any future gains by the new owners?

**4.6** Treasury guidance recommends that departments consider obtaining planning permission to enhance the value of properties before they are sold. If there are doubts about what type of development would secure the best price, the guidance recommends exploring the possibility of a clawback on any increase in value achieved after the sale resulting from planning permission being secured. Professional advisers should assess the likely effects of any clawback proposals on the sale price achievable.

**4.7** The Department’s property advisers, Savills, estimated that development potential for the estate as a whole was worth about £18 million over 10 years (Figure 10, item i) in broad terms. The Department did not seek to establish the development potential for specific sites or obtain planning permission for the married quarters sold. The timing of the surrender of the retained quarters was uncertain, and the Department and their financial advisers (NatWest Markets) considered that the risks and rewards of property development should rest with the new owner.

**4.8** The Department and their advisers considered it appropriate to seek a clawback on the gains from an early wholesale disposal soon after buying the estate from the Department, and terms which would not penalise prospective new owners for gains they might foresee from holding or developing the properties themselves. NatWest Markets considered that a clawback on higher than expected profits realised up to 15 years after the sale would have a broadly neutral impact on proceeds for the Department - the likely clawback receipts at least matching any reduction in the sale price offered. But a clawback on a *normal* level of profits, and extending over many years, would reduce the likely sale price disproportionately.

**4.9** The Department therefore built into the sale a clawback, detailed in Appendix 6, that aimed to satisfy these considerations. It involved a share of disposal profits, starting at 50 per cent and reducing in steps to nothing after 15 years, and a profit threshold below which there would be no clawback. The Department will not have to contribute to meeting any losses by the new owners. The clawback will remain dormant while the new owners continue to hold the properties, and be triggered when any gains are realised through:

- a) disposal of the properties themselves; or
- b) disposal, or dilution, of an ownership “interest” in the properties, such as a sale of shares of Annington Group companies (such ‘deemed’ disposals are described in Appendix 6).

As at June 1997, the Exchequer had received £1.25 million through the clawback arrangements.

**4.10** The sale contract requires the new owners to submit a “disposals statement”, identifying and quantifying physical and ‘deemed’ disposals, each year or immediately following a disposal worth £1 million or more. The Department recognise that checking the statement, and monitoring events more generally to establish whether the clawback has been triggered, will be difficult, involving monitoring of property sales and the financial markets. They plan to engage external advisers to police the clawback on their behalf. They have recently let a two-year contract to Herbert Smith (who had been involved in the sale) for the legal aspects of this work, and plan to let a further contract for the accountancy aspects.



## Main points

**4.11** The Department included in the sale contract a clawback on future gains made by the new owners. So far, the Exchequer has received 1.25 million through these arrangements.

## What are the arrangements for terminating underleases?

**4.12** In putting together the sale package, the Department sought to give the prospective owners opportunities to take possession of sufficient houses to meet any aspirations they might have for redevelopment, and for supplying homes to other customers. The Department therefore provided breakpoints in the underlease at the 25th year and at subsequent 15 year intervals (twenty-five year property leases are common in the commercial sector).

**4.13** The Department also sought to ensure that they would have sufficient married quarters to meet their long term needs. They decided that an underlease of 200 years would give them a sound contractual basis for leasing married quarters and security of tenure, should their requirement continue in the long term. In particular, rather than having renewable shorter leases as originally envisaged, the long underlease would:

- a) place the onus of breaking the underlease on the new owners, rather than on the Department having to seek renewal of underleases;
- b) give the Department stronger legal grounds for continuing their use of sites pending the outcome of any arbitration over disputed underlease terminations; and
- c) allow the Department to set a minimum period of grace before they would have to vacate the sites.

**4.14** Under the terms of the sale, the new owners may break the underlease for particular sites - at the defined breakpoints - on one of two grounds:

- a) by offering comparable alternative accommodation, provided it meets comparability criteria which have been set by the Department - including such factors as travel-to-work time, the standard of nearby schools and job

opportunities for spouses. Plans for such a 'site exchange option' during the first 25 years were withdrawn during final sale negotiations with Annington, who offered to do without it; or

- b) if, in accordance with Landlord and Tenant Acts, they wish to redevelop an entire site, or so much of it that complete repossession would be needed (if the new owners need only a part of the site to carry out the redevelopment, the Department would have the right to stay in the remainder). The new owners would have to be able, if challenged legally, to demonstrate intention and ability to redevelop. The Department would be entitled to compensation of two years' rent.

**4.15** The Department added conditions to the sale contract, however, to ease the concerns of the Services about ensuring possession of the sites they needed in the long term, and to reduce the likelihood of terminations they would oppose and their inconvenience and cost to the Department:

- a) For sites not "behind the wire", the Department will be able to veto underlease terminations for redevelopment which would severely prejudice the operational effectiveness of the associated military base (the new owners cannot terminate leases on quarters behind the wire because they lie within security perimeters).
- b) The Department will be able to remain on the site for 30 months after the underlease breakpoint, or after an adverse arbitration on an opposed termination, whichever were later. This would ensure a minimum four years' notice for the Department from the time the new owners notify their intention to terminate an underlease, whether or not the Department opposed the termination.
- c) The new owners will not be able to rely on an intention to demolish the houses to secure a termination of the underlease - the normal legal provisions for leases in the commercial sector allow this.

**4.16** The Department will have commitments in connection with sites they surrender, or for which the underleases are terminated. If they choose to surrender houses 'behind the wire' - a fifth of the 'retained' quarters - they will have to build new access roads, realign security fences or carry out other works to give the new owners access without having to go through parts of the estate where access is limited. If they cannot, they will have to continue paying rent on the surplus houses on those sites, and maintain them. Under the sale, the Department have to surrender houses in a 'tenantable condition', and they can only avoid their

maintenance obligations by demolishing the houses with the new owners' consent. In such circumstances, the Department may have to pay compensation or reinstate the housing lost.

**4.17** About a third of the married quarters are dependent on the military bases to which they relate for the supply of utilities, and under the sale the Department will continue to provide these services while they continue to lease more than 25 per cent of the quarters at such sites. However, if the Department surrender more than 75 per cent of the quarters at such sites before the first lease breakpoint, they may choose to continue supplying these services for 60 years or contribute one third of the conversion costs, subject to site- and utility-specific limits. If underleases ceased for all utility-dependent sites in the first 25 years, the Department's maximum liability would amount to £25 million, but they will incur no liability for leases surrendered after 25 years. The Department consider that without these utility provisions, the sale price would have been depressed disproportionately.

## **Main points**

**4.18** The main points are:

- a) For sites "behind the wire", the new owners cannot terminate the underlease, and the Department cannot surrender them without first providing physical access.
- b) For other sites, the new owners may terminate the 200-year underlease after 25 years or at subsequent breakpoints every 15 years after that. To do so, however, they would either have to offer comparable alternative accommodation or be able, if challenged, to demonstrate an intention and ability to redevelop the site.
- c) The Department could prevent terminations, satisfying these criteria, by exercising a veto over those which would severely prejudice operational effectiveness. For terminations for development that do proceed, the Department would receive compensation from the new owners worth two years' rent and have four years' notice to leave.

# Appendix 1

## Chronology of the sale

### Historical background

1660s	The inception of the Standing Army and an end to the practice of commandeering civilian property to house soldiers (made illegal in 1677).
1790	The first serious consideration given to the need to build suitable barracks and quarters to accommodate military personnel, with the appointment of a Barrack Master General (1792) specifically to construct barracks.
1840s	The concept of 'married quarters', which had been gradually evolving through regimental practice rather than official policy, became recognised when individual regiments began to set aside separate rooms in barracks for soldiers' families.
c1860-80	Regulations specified, for the first time, the conditions under which some Service families could be accommodated on military bases, and Army Acts legalised the billeting of soldiers outside camp (mainly in inns).
1914-18	The First World War did not involve the provision of married quarters. Married men received an allowance with which to maintain their families.
1918 -	Use of married quarters accommodation grew under various authorities and practices, in particular by extending Army Act billeting powers to allow servicemen to be accommodated in houses off-base.

### Events surrounding the sale

#### The Housing Trust

1991	The Secretary of State for Defence announced his intention to establish a Housing Task Force to examine Service housing.
24 February 1992	Two reports by the Housing Task Force published, recommending, amongst other things, the establishment of a non profit-making organisation to take over from the Department the ownership and management of the married quarters estate.

31 March 1993	The Minister of State for the Armed Forces announced the proposed establishment of a non profit-distributing Housing Trust, to own the married quarters estate.
July 1993	External advisers appointed to develop the Housing Trust proposals.
March 1994	A consortium of advisers appointed to support the embryonic Housing Trust.
August 1994	The Housing Trust arrangements abandoned because the structure of the proposals would not enable sufficient risk to be transferred to the private sector to constitute a valid privatisation.
<b>The Married Quarters Sale</b>	
November 1994	NatWest Markets appointed to help develop new outline proposals for transferring the married quarters to the private sector.
April 1995	NatWest Markets reappointed to take forward proposals to sell the married quarters estate to a single private sector purchaser. Other principal advisers appointed around this time.
28 November 1995	Launch of the sale with the publication of the Preliminary Information Memorandum to attract prequalification applications from interested parties.
23 February 1996	Publication of the full Information Memorandum inviting indicative offers from prospective purchasers, starting the first round of the bidding process.
22 May 1996	Final offers invited from four shortlisted tenderers, starting the second round of the bidding process.
16 August 1996	Best and final offers invited from two bidders.
3 September 1996	The preferred bidder (Annington) given 15 days to settle outstanding issues and be ready to exchange contracts.
24 September 1996	Exchange of contracts between the Department and Annington Homes.
5 November 1996	Completion of the sale and receipt by the Department of the initial payment (£961,640,000, less the initial rent due).
1 April 1997	Receipt of the remaining £700 million of sale proceeds from Annington Homes.

## **The Future**

November 1999	First of rolling programme of five-yearly rent reviews, based on open market rent comparisons.
November 2021- November 2024	First breakpoints in site underleases, at which time Annington Homes may exercise options to terminate underleases on redevelopment grounds or by offering alternative sites in exchange, subject to Departmental veto on operational grounds. Breakpoints at 15 year intervals thereafter.
November 2196	Expiry of the 200-year site underleases. At this point, the headlessee (currently Annington Homes) may acquire the freehold from the Department for any remaining leased quarters, or negotiate further underleases with the Department.
November 2995	Expiry of the 999-year headleases, with ownership of any remaining quarters still being leased to the headlessee reverting to the Department.

## Appendix 2

### National Audit Office methodology

**1** The National Audit Office examined the steps the Department took to manage the sale of their married quarters properties in England and Wales. The National Audit Office considered:

- why the married quarters estate was sold;
- how the sale was structured;
- how the estate was sold;
- how the Department decided whether to proceed with the sale; and
- how the Department have sought to protect their future interests.

**2** The examination focused on how far the major decisions made by the Department in their conduct of the sale ensured that the highest price was obtained from the market and Service interests were contractually safeguarded, given the sale objectives and pre-conditions.

**3** The main aspects of the National Audit Office's methodology were:

- the collection and evaluation of information from the Department - mainly from the Housing Project Team who managed the sale and the Defence Housing Executive - relating to the development of the Housing Trust scheme, the sale itself and some aspects of past performance in managing the married quarters estate;
- a review of the work of the Department's consultants;
- consulting the Treasury about their involvement in advising the Department; and
- discussing the sale process with the four final bidders.

- 4** The National Audit Office also evaluated:
- the approach adopted on the sale compared with good practice, with particular reference to past reports by the Committee of Public Accounts and to Treasury guidance;
  - the basis of the decisions taken by the Department, and whether these were consistent with the Department's sale objectives and pre-conditions; and
  - the information available to the Department, and whether their decisions were taken on the basis of appropriate professional advice.



## Appendix 3

### Summary of Committee of Public Accounts Recommendations and Treasury Guidance on Property Sales

<i>Committee of Public Accounts Recommendations</i>	<i>Treasury Guidance for Departments</i>	<i>Current Report References</i>
<p><b>1. Sale Objectives</b></p> <p>Departments should ensure their strategy is directed towards clear and specific disposal objectives (10th Report 1986-87, para 22(ii), HC234).</p>	<p>Departments should give initial consideration to the objectives for the sale. These will probably need to be refined....and sale objectives should be agreed with the Treasury. Objectives should not all be directly linked to maximising sale proceeds ... (Trade Sales guidance<sup>2</sup>: paras 5.1 &amp; 5.3)</p> <p>The starting point should be a statement of the strategic context,... and there should be a clear statement of objectives to be achieved ... to set a firm boundary to the appraisal of options, and to provide criteria against which options should be judged and the success of the project evaluated after the event. (Property Options<sup>3</sup>, paras 3.1-3.2)</p>	<p>The Department set objectives and pre-conditions for the sale, which were refined as the sale proposals were themselves developed, and objectives took account of the Department's policy regarding the provision of housing for Service personnel and their families, and the need to improve the level of empty married quarters (<b>paragraphs 1.10-1.11</b>)</p>
<p><b>2. Preparation for Sale</b></p> <p>Departments should make a careful assessment of the most appropriate methods of sale in order to maximise proceeds (34th Report 1987-88, para 3(iv), HC211)</p>	<p>Professional advice should be obtained on sale methods. (DAO(GEN) 11/96<sup>1</sup>, para 24)</p>	<p>The Department decided on a sale of the married quarters estate to a private sector purchaser following the abandonment of their Housing Trust proposals (<b>paragraph 1.8</b>). They decided on a bulk, unitary sale to a single purchaser. They recognised that this approach might involve a discount on the possible proceeds from piecemeal disposal but noted too that there were financial and other advantages from a single sale (<b>paragraph 2.2</b>). The Department took professional advice in developing their sale proposals (<b>paragraphs 2.2 and 2.17</b>).</p>

continued...

<i>Committee of Public Accounts Recommendations</i>	<i>Treasury Guidance for Departments</i>	<i>Current Report References</i>
	<p>In appointing a financial adviser to conduct feasibility studies, departments should have regard to the presumption that the appointment of external consultants should be on a competitive basis. (Trade Sales<sup>2</sup>, para 6.1)</p>	<p>The Department's main advisers were generally appointed following competition. Two advisers were retained for the sale after being appointed through competition for earlier Housing Trust work (<b>paragraph 2.19</b>), and the Government Property Lawyers were chosen without competition because the Department considered them best placed to undertake their tasks (they already held the title deeds, and had worked on the Housing Trust scheme).</p>
	<p>Subject to certain exceptions, property may need to be offered back to the former owner or the former owner's successors or, if residential, to a sitting tenant. (DAO(GEN) 11/96<sup>1</sup>, para 9 and Annex).</p>	<p>The Department included in the sale some 150 properties (on six sites) which are potentially subject to arrangements requiring them to be offered back to former owners in accordance with the 'Crichel Down' Rules. The Rules may come into force when surplus quarters are surrendered by the Department to the new owners. The sale contract requires the Department to make best endeavours to maximise the price achieved at the time in any such sale, the proceeds of which would go to the Annington Group.</p>
<p><b>3. Method of Sale</b></p> <p>Assets should be exposed to the market unless there are compelling reasons to the contrary (10th Report 1986-87, para 12, HC234).</p> <p>We reiterate the principle, endorsed by a former Committee of Public Accounts, that assets should be sold in competition unless there are compelling reasons to the contrary. It is not only that this is generally the best way of securing the highest price: it also helps demonstrate that public assets have been sold transparently with due regard for probity. (22nd report 1993-94, para 3(iv), HC210).</p>	<p>Professional advice should be obtained on sale methods. Normally sale by auction or competitive tender should ensure that a genuine market price for the property is reached, provided there is effective marketing. Sales by auction or tender also provide very strong evidence that the sale was made in a fair way and that the best price was obtained. (DAO(GEN) 11/96<sup>1</sup>, para 24).</p>	<p>The Department decided on a competitive tender method of sale to maintain competitive tension between bidders and maximise sale price. The Department used consultants to generate, measure and maintain significant interest in the market (<b>paragraph 2.23</b>).</p>

continued...

<i>Committee of Public Accounts Recommendations</i>	<i>Treasury Guidance for Departments</i>	<i>Current Report References</i>
<p><b>4. Valuations</b></p> <p>We underline the importance that sales are backed up by up-to-date valuations ... (13th Report 1989-90, para 3(v), HC352) .</p>	<p>Before property is offered for sale, [departments] should obtain professional valuation advice to establish a guide price and, in the case of a sale by auction or tender, a provisional reserve price. In major or potentially difficult cases ... a professional valuer independent of the selling agent should be appointed to provide a report on the development prospects and to undertake the initial valuation ... (DAO(GEN) 11/96<sup>1</sup>, para 23).</p> <p>Where private sector valuers or agents are used to carry out valuations and sale of property, professionally qualified firms, ie those having members of the Royal Institution of Chartered Surveyors or Incorporated Society of Valuers and Auctioneers among their partners or directors, should normally be appointed. (DAO(GEN) 11/96<sup>1</sup> para 23(i)).</p> <p>Where a professional valuer independent of the selling agent is appointed his functions should include:</p> <ul style="list-style-type: none"> <li>■ establishing an initial guide price;</li> <li>■ advising ... on the final reserve price in sales by tender or auction;</li> <li>■ advising on any authentic late or revised bid received ...</li> <li>■ where the final sale is at a price below the initial guide price, certifying, jointly with the selling agent, that it is the best offer reasonably obtainable (DAO(GEN) 11/96<sup>1</sup>, para 23(h)).</li> </ul> <p>... The selling agent should consider whether the initial valuation needs to be revised in the light of changed market circumstances and the results of the marketing of the property before a final reserve price is set. The final reserve figure should normally be set as near to the time of the auction or tender as possible (DAO(GEN) 11/96<sup>1</sup>, para 24).</p>	<p>The Department obtained professional valuation advice for different sale scenarios and on different assumptions, prior to concluding the sale (<b>paragraph 3.2</b>). They appointed a professional valuer (Savills), independent of the selling agent (<b>Figure 5</b>), to undertake a range of valuation tasks in relation to the properties and the characteristics of the sale itself (<b>paragraph 3.2</b>).</p> <p>In developing their proposals to sell the married quarters estate, the Department identified two main benchmarks against which they evaluated the benefits of proceeding with the sale (<b>paragraph 3.1</b>). The Department commissioned Savills to reperform their valuations, and subsume different assumptions, during the sale (<b>paragraph 3.2</b>).</p>

continued...

<i>Committee of Public Accounts Recommendations</i>	<i>Treasury Guidance for Departments</i>	<i>Current Report References</i>
<p>Where land is considered to have development potential serious consideration should be given to all the options for protecting the taxpayer's interest, including a separate sale or the use of clawback provisions. (13th Report 1989-90, para 3(v), HC352).</p>	<p>Land which has potential for development will normally secure the best price if sold with the benefit of planning provision ... and planning permission should be sought accordingly including the improvement of existing consent where this seems likely to be advantageous (DAO(GEN) 11/96<sup>1</sup>, para 16)</p> <p>Departments ... are advised to obtain explicit [professional] advice on whether there is likely to be potential for development and on the nature of such development and/or whether there are particularly sensitive planning issues. (DAO(GEN) 11/96<sup>1</sup> para 14)</p>	<p>The Department did not seek to establish planning permission for the married quarters sold because the timing of the surrender of the retained quarters was uncertain and the Department and their advisers looked to the new owners to make normal profits from property development as a reward for absorbing this risk (<b>paragraph 4.7</b>).</p>
<p><b>5. Clawback</b></p>		
<p>We encourage [departments] to consider the use of clawback provisions ... where there are real doubts over the basis for valuation and the possibility of windfall profits to the purchaser ... Clawback should not be so frequently used as to interfere with orderly and timely disposal. (10th Report 1986-87, para 20, HC234).</p>	<p>Departments should consider the need for a clawback arrangement where land or property with an alternative use value is sold ... The case for using clawback mechanisms should be assessed in the particular circumstances of each sale, bearing in mind:</p> <ul style="list-style-type: none"> <li>■ the complexity of the clawback mechanism; and</li> <li>■ the risk that proceeds may be adversely affected by an amount greater than the potential return ...</li> </ul> <p>(Trade Sales guidance<sup>2</sup>, paras 22.1 &amp; 22.4)</p>	<p>The Department took professional advice in designing their clawback arrangements (<b>paragraphs 4.7-4.9</b>). The Department built into the sale a clawback on exceptional or early profits, taking account of the potential impact on sale proceeds and the complexity of different clawback mechanisms (<b>paragraph 4.9 and Appendix 6</b>).</p>
<p>The case for selling property subject to clawback conditions should be considered on its merits in each case. (22nd Report 1993-94, para 3(v), HC210). Consideration should be given to whether the benefits accruing from clawback outweigh the benefit of securing complete disengagement. (10th Report 1986-87, para 41).</p>	<p>Departments are recommended to view any proposals for profit clawback with particular caution. Investors are unlikely to view positively any scheme diminishing the potential gains from improvements ... or from ... on-sale ... Departments need to weigh the risk that sales proceeds would be reduced by an amount greater than any benefit that may be gained from profit clawback. (Trade Sales guidance<sup>2</sup>, para 22.5)</p>	<p>The Department and their professional advisers assessed the likely affects of different clawback structures on the sale price (<b>paragraph 4.8</b>).</p>
<p>Professional advisers should be able to give an assessment of the likely effects of a clawback clause on the sale price. Departments ... will also wish to consider with the appropriate professional advice whether a clawback provision should be included to cover the purchaser significantly improving a planning consent to his advantage ... The inclusion of a clawback provision should also be considered where it is decided to sell the land subject to a planning brief rather than with outline or detailed planning consent. (DAO(GEN) 11/96<sup>1</sup>, para 20).</p>		

continued...

<i>Committee of Public Accounts Recommendations</i>	<i>Treasury Guidance for Departments</i>	<i>Current Report References</i>
<b>6. Conduct of the Sale</b>	<p>The vendor will generally receive maximum sales proceeds by promoting the widest possible competition, wherever practicable and consistent with the sales objectives: (Trade Sales guidance<sup>2</sup>, para 24.2)</p> <p>Deadlines should be set with a view to ensuring the efficient conduct of the sale but should not be so tight as to constrain the pursuit of value for money for the taxpayer; (Trade Sales guidance<sup>2</sup>, para 24.2)</p> <p>Care should be taken to accord potential and actual bidders equality of information at each stage of the sale process; (Trade Sales guidance<sup>2</sup>, para 24.2)</p> <p>Departments must ensure that a proper record of information and advice passed to bidders is kept, to ensure that Government can show that all parties have been fairly treated. (Trade Sales guidance<sup>2</sup>, para 24.2)</p> <p>As a general rule suitably qualified agents from the private sector will need to be appointed to handle sales (DAO(GEN) 11/96<sup>1</sup>, para 23(f))</p> <p>The vendor may wish to consider asking the firm which completes any feasibility report also to handle the main [sale]. In doing so, departments should consider whether it would be foregoing any benefits that could arise from a full competition. (Trade Sales guidance<sup>2</sup> para 7.1)</p> <p>When negotiations on indicative bids are substantially complete, the vendor should decide, taking account of the views of its financial adviser, whether further to shortlist bidders at this stage. Subject to that decision, an invitation should be issued to bidders to submit final bids, or to take part in more than one further round of bidding. (Trade Sales guidance<sup>2</sup> para 32.1)</p>	<p>The Department sought to maximise sale proceeds through widely marketing the sale and maintaining competitive tension throughout the bidding process <b>(paragraph 2.23)</b>.</p> <p>The Department set deadlines for bidder responses at all stages of the bidding process <b>(paragraph 2.25)</b>. The Department also included warranties in the sale, in recognition of the scale of the 'due diligence' task in the timescales against which bidders were required to respond <b>(paragraph 2.27)</b>.</p> <p>The Department issued a Preliminary Information Memorandum and an Information Memorandum to elicit applications to prequalify for the sale <b>(paragraph 2.23)</b>. The Department established a data room for second round bidders to ensure the sharing of key sale information <b>(paragraph 2.26)</b>.</p> <p>The Department maintained a record of information and advice passed to bidders. This was examined by the National Audit Office in the course of their examination <b>(Appendix 2)</b>.</p> <p>The Department appointed NatWest Markets as their main financial adviser and selling agent <b>(Figure 5)</b>. NatWest Markets conducted the initial study of options for the sale, following competition, and were required to compete again for the contract to develop the sale package and to manage and market the sale. Following their evaluation of indicative bids, the Department conducted three more bidding rounds before final negotiation with their preferred bidder <b>(Figure 6)</b>.</p>

continued...

<i>Committee of Public Accounts Recommendations</i>	<i>Treasury Guidance for Departments</i>	<i>Current Report References</i>
<p>In the final analysis, we consider that the achievement of value for money depends on those responsible for the disposal of public assets pushing as hard for a good deal as they would if selling their own property. (43rd Report 1994-95, para 3(xxviii), HC502)</p>	<p>Vendors should consider whether to undertake checks on bidders' credentials. The stage at which, and the extent to which, these checks are undertaken will vary according to the sale exercise, but should in any event take place before a preferred bidder is selected. (Trade Sales guidance<sup>2</sup> para 33.1)</p>	<p>The Department and their advisers developed and applied evaluation criteria for assessing bidding consortia and their financial credentials (<b>paragraph 2.28 and Box 4</b>). The Department's financial and legal advisers prepared written reports on their assessment of bidders' proposals.</p>
<p>... all offers received prior to a binding legal agreement being entered into should be thoroughly investigated and the bidders given the fullest opportunity to establish their financial credentials. (12th Report 1990-91, para 3(ii), HC374).</p>	<p>Where agents are used to establish the creditworthiness and development track record of bidders, it is recommended that departments ... ensure that they obtain in writing the advice, and the nature of the evidence on which it is based, in respect of the bid which it is proposed to accept and any higher bids which are recommended for rejection because of doubts about the bidders' financial credentials and development track record. (DAO(GEN) 11/96<sup>1</sup>, para 27)</p>	<p>The Department received from their selling and legal agents clear recommendations based on proper consideration of bidders' offers and their financial standing, at each stage of the bidding process (<b>paragraphs 2.29-2.31</b>).</p>
	<p>Departments ... should instruct agents that they must provide clear recommendations as to which tender should be accepted, based on proper analysis of the offers and investigations of the adequacy of the prospective purchasers' financial standing and that this advice should take into account factors which affect the risk to which the vendors may be exposed. (DAO(GEN) 11/96<sup>1</sup>, para 23(g)).</p>	
	<p>Written advice should be obtained from legal advisers as to the precise effects of all contract terms (DAO(GEN) 11/96<sup>1</sup>, para 23(j)).</p>	
	<p>Property should normally be sold for the highest bid which at least equals any reserve price. Where ... the reserve price is not reached and the highest bid is only marginally lower than the reserve, a department... should seek advice from its professional advisers on whether it would nevertheless be worthwhile accepting that bid. (DAO(GEN) 11/96<sup>1</sup>, para 24).</p>	<p>The Department concluded the sale with the highest of the final bids (<b>paragraph 2.31</b>). In proceeding with the sale, the Department noted that the purchase price was less than the value of owning and managing the estate in-house indicated by the investment appraisal - the target price (<b>paragraph 3.28</b>).</p>
	<p>Following a decision on one or more preferred bidder, the vendor should seek to complete the sale as soon as possible. The vendor should use any leverage presented by the retention of more than one preferred bidder to negotiate to maximise the sale proceeds. (Trade Sales guidance<sup>2</sup>, para 34.2).</p>	<p>The Department exchanged contracts with the preferred bidder (Annington Homes) three weeks after notifying them that they were the Department's choice (<b>paragraph 2.31</b>). The sale was completed six weeks after exchange of contracts (<b>Figure 6</b>).</p>

continued...

**Committee of Public Accounts  
Recommendations**

**Treasury Guidance for Departments**

**Current Report References**

**7. Sale Costs**

We emphasise, without wishing to add to administrative burdens, the importance of a record of sales costs that is sufficiently accurate for management to be able to identify the main trends. (22nd Report 1993-94, para 3(vii), HC210.)

Departments should make early arrangements to ensure that sale costs can be separately identified, forecast and monitored. (Trade Sales guidance<sup>2</sup>, para 13.1)

The Department established arrangements to identify and control sale costs (**paragraph 2.39**).

1. "Disposal of Land and Buildings and other Land Transactions by Government departments and non-departmental Public Bodies" (DAOGEN 11/96)
2. "Trade Sales Including Management Buy-outs", HM Treasury, July 1996
3. "The Economic Appraisal of Property Options : A Manual of Procedures and Techniques", HM Treasury, December 1993.

## Appendix 4

### Procurement method, type of contract and expenditure in relation to the Department's main advisers

<i>Advisers/ agents</i>	<b>Main tasks</b>	<b>Procurement method</b>	<b>Type of contract</b>	<b>Department's cost estimates, and actual expenditure</b>
<i>NatWest Markets</i>	i) Initial study of options for sale	Competition	Fixed price	£90,000
	ii) Developing the sale package, managing bidding rounds and marketing the sale, and financial modelling	Competition  A second firm was shortlisted from four bids received, but was rejected because of its preference for a divided or phased sale, rather than a unitary sale (paragraph 2.2)	Combination of monthly flat-rate, time-based fees and a commission of 0.1% of sale price in excess of £520m.	Estimate £4,050,000 Expenditure <u>£4,614,000</u> (£ 564,000)  Difference due to higher than previously expected Sale price (increasing commission payments), and slippage (increasing total monthly payments).
<i>Herbert Smith</i>	Preparation of legal documentation, co-ordination of due-diligence arrangements, drafting profit-sharing (clawback) terms (paragraph 4.9) and organising what the Department believe was the largest residential conveyancing ever undertaken.	Competition.	Time-based fees, with some more easily estimated tasks having a fee limit.	Estimate £1,653,000 Expenditure <u>£3,256,000</u> (1,603,000)  Difference due to reallocation of work between legal advisers, and the cost of dealing with the complexities of the developing sale arrangements.

continued...



<i>Advisers/ agents</i>	<b>Main tasks</b>	<b>Procurement method</b>	<b>Type of contract</b>	<b>Department's cost estimates, and actual expenditure</b>	
<i>Government Property Lawyers</i>	Investigation of property title and conveyancing.	Not competed. The Department considered that the Government Property Lawyers were best placed for these tasks - they already held the title deeds, and had already undertaken initial work associated with the Housing Trust project.	Time-based fees, with fee limits	Estimate	£1,314,000
				Expenditure	<u>£ 515,000</u> £ 799,000
					Difference due to less work allocated than originally envisaged. They did not have the manpower available to deal with all legal tasks in the time available.
<i>Savills</i>	Estate valuations (paragraph 3.2), and preparation of the Asset Register and ancillary documentation for the sale.	Not competed for the Sale: Savills had been selected for earlier Housing Trust work, through competition. They were retained for the sale itself because of the expertise they had built-up.	Time -based fees with fee limits on individual tasks	Estimate	£1,016,000
				Expenditure	<u>£1,146,000</u> (£ 130,000)
					Difference due to additional valuation tasks, including valuation of the sale from bidders' perspective (paragraph 3.2).
<i>Price Waterhouse</i>	Accounting advice	Competition	Time-based fees with fee limits on individual tasks	Estimate	£ 420,000
				Expenditure	<u>£ 105,000</u> £ 315,000
					Difference arose because less work was required than originally anticipated, as the structure of the sale evolved.

continued...

<i>Advisers/ agents</i>	<b>Main tasks</b>	<b>Procurement method</b>	<b>Type of contract</b>	<b>Department's cost estimates, and actual expenditure</b>	
<i>Brunswick</i>	Production of public relations strategy.	Competition	Time-based fees, with overall fee limit and expenses limit	Estimate Expenditure	£ 325,000 <u>£ 389,000</u> (£ 64,000)
					Difference arose from the addition of <b>internal</b> public relations work (in connection with the services and Service families).
<i>Coopers and Lybrand</i>	Financial advice, including assistance with the investment appraisal (paragraph 3.5)	Not competed for the Sale: Coopers & Lybrand had been selected for earlier Housing Trust work, through competition.	Time-based fees, with limits for each month	Estimate Expenditure	£ 167,000 <u>£140,000</u> £ 27,000
<i>Sir Alexander Gibb and Partners Ltd</i>	Estimating costs of utility services at utility-dependent sites (paragraph 4.17).	Competition	Time-based fees, with fee limits for each task and an overall fee limit	Estimate Expenditure	£ - <u>£ 150,000</u> (£ 150,000)
					Requirement for this work was not envisaged when the Department made their cost estimates.

Source: National Audit Office analysis of the Department's papers

## Appendix 5

### The Department's investment appraisal

This Appendix shows summary data behind the Department's investment appraisal calculations:

- Figure A (on page 72) shows the values, against which the Department compared the sale price achieved, for the Department's seven in-house management scenarios (Figures 10 and 11 of the main report). These values ranged from £1,552 million to £1,953 million over a 25 year period, and from £1,557 million to £2,005 million over a 30 year horizon.
- Figure B (on page 73), in a similar way, shows the range of values under the sensitivity assumptions for rent levels, the extent of the Department's future occupancy and possible difficulties in renewing leases after 25 years (Figures 13 and 14 of the main report). Values produced by these sensitivity analyses ranged from £1,456 million to £1,917 million over a 25 year period, and from £1,467 million to £2,009 million over 30 years.

The numbers in **bold** are those plotted in Figures 11 and 14 of the main report.

**Figure A: Investment appraisal summary data for in-house scenarios 1 to 7 (Figures 10 and 11 of the main report), over 25 and 30 years**

	Scenarios														
	1		2		3		4		5		6		7		
	£ million		£ million		£ million		£ million		(Main comparator) £ million		£ million		£ million		
Notes	25yrs	30yrs	25yrs	30yrs	25yrs	30yrs	25yrs	30yrs	25yrs	30yrs	25yrs	30yrs	25yrs	30yrs	
(i) Net present value of in-house scenario															
■ Income from sale of surpluses	1	396	433	348	386	290	327	296	324	240	267	217	245	0	0
■ 'Special Sales' proceeds	2	33	33	33	33	33	33	33	33	33	33	33	33	0	0
■ Redevelopment income	3	17	17	17	17	17	17	17	17	14	14	14	14	0	0
■ Rental proceeds	4	0	0	21	23	7	8	0	0	21	23	7	8	0	0
■ MoD management costs	5	-20	-22	-22	-25	-24	-26	-20	-22	-22	-25	-24	-26	-39	-46
■ Maintenance of houses rented out.	6	0	0	-17	-19	-16	-19	0	0	-17	-19	-16	-19	-67	-82
■ Fees to external advisers	7	-18	-19	-16	-18	-15	-16	-18	-19	-16	-18	-15	-16	0	0
■ Residual value of houses after 25/30 years.	8	283	188	300	202	313	212	212	141	225	151	234	159	395	310
Net total		691	630	664	599	605	535	520	473	476	426	449	396	289	182
(ii) Net present value of operating under the sale (Figure B, Column A)		-1235	-1348	-1235	-1348	-1235	-1348	-1235	-1348	-1235	-1348	-1235	-1348	-1235	-1348
(iii) Payment in two tranches	9	-27	-27	-27	-27	-27	-27	-27	-27	-27	-27	-27	-27	-27	-27
(iv) Sale price needed to match in-house scenarios [i less (ii + iii)]		<b>1953</b>	<b>2005</b>	<b>1926</b>	<b>1974</b>	<b>1867</b>	<b>1910</b>	<b>1782</b>	<b>1848</b>	<b>1739</b>	<b>1801</b>	<b>1712</b>	<b>1771</b>	<b>1552</b>	<b>1557</b>

**Figure B: Investment appraisal summary data for sensitivity analysis on in-house 'Scenario 5' (Figures 13 and 14 of the main report), over 25 and 30 years**

		<i>Sensitivities applied to Scenario 5</i>																	
		A		B		C		D		E		F		G		H		I	
		Scenario 5		£ million		£ million		£ million		£ million		£ million		£ million		£ million		£ million	
Notes		25yrs	30yrs	25yrs	30yrs	25yrs	30yrs	25yrs	30yrs	25yrs	30yrs	25yrs	30yrs	25yrs	30yrs	25yrs	30yrs	25yrs	30yrs
(i) Net present value of in-house scenario 5																			
■	Income from sale of surpluses	1	240	267	266	302	217	238	189	209	82	82	121	129	355	408	409	467	267
■	'Special Sales' proceeds	2	33	33	33	33	33	33	33	33	33	33	33	33	33	33	33	33	33
■	Redevelopment income	3	14	14	14	14	13	13	12	12	14	14	14	14	14	14	14	14	14
■	Rental proceeds	4	21	23	23	26	19	20	16	18	7	7	11	11	31	35	41	44	23
■	MoD management costs	5	-22	-25	-22	-25	-22	-25	-22	-25	-21	-23	-21	-23	-24	-26	-25	-27	-25
■	Maintenance of houses rented out.	6	-17	-19	-17	-19	-17	-19	-17	-19	-5	-5	-8	-9	-26	-30	-43	-49	-19
■	Fees to external advisers	7	-16	-18	-16	-18	-16	-18	-16	-18	-6	-6	-9	-9	-23	-26	-26	-30	-18
■	Residual value of houses after 25/30 years.	8	225	151	287	203	175	112	162	109	344	270	313	239	129	51	93	19	151
	Net total		476	426	569	517	401	355	357	319	447	371	453	384	488	459	495	471	426
(ii) Net present value of operating under the sale																			
■	Rents paid by MOD	10	-1266	-1376	-1367	-1509	-1179	-1265	-1079	-1161	-1419	-1611	-1379	-1549	-1155	-1197	-1059	-1066	-1376
■	MOD's profit share receipts	11	30	30	34	34	25	25	23	23	24	24	25	25	35	35	39	39	30
■	Internal MoD costs	5	-16	-18	-16	-18	-16	-18	-16	-18	-16	-18	-16	-18	-16	-18	-16	-18	-18
■	External advisers to MoD	7	-39	-40	-39	-40	-39	-40	-39	-40	-39	-40	-39	-40	-39	-40	-39	-40	-40
■	Utilities 'untying'	1	-6	-6	-6	-6	-6	-6	-6	-3	-3	-3	-3	-3	-9	-8	-11	-11	-6
■	MoD third-party income	12	0	0	0	0	0	0	0	0	0	0	0	0	0	0	31	28	0
■	Capital Gains Tax, Stamp Duty, Council Tax and VAT on maintenance.	13	62	62	72	73	53	53	45	44	44	45	44	45	87	89	100	99	62
■	Compensation for lease renewal at 25 years (Sensitivity I, Figure 13).	14	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-24
	Net total		-1235	-1348	-1322	-1466	-1162	-1251	-1072	-1158	-1409	-1603	-1368	-1540	-1097	-1139	-955	-969	-1399
(iii)	Payment in two tranches	9	-27	-27	-27	-27	-27	-27	-27	-27	-27	-27	-27	-27	-27	-27	-27	-27	-27
(iv)	Sale price needed [i less (ii + iii)]		<b>1739</b>	<b>1801</b>	<b>1917</b>	<b>2009</b>	<b>1589</b>	<b>1632</b>	<b>1456</b>	<b>1503</b>	<b>1883</b>	<b>2002</b>	<b>1848</b>	<b>1950</b>	<b>1612</b>	<b>1626</b>	<b>1478</b>	<b>1467</b>	<b>1826</b>

- 
- Notes 1. **Utilities**  
The cost of providing utilities to utility-dependent sites was estimated at £6 million in present value terms. Under the in-house options, the Department adjusted the estimated proceeds from selling surplus houses to reflect the cost to the Department of providing utilities.
- The costs of works to surrender “*behind the wire*” quarters is not included in the investment appraisal because it is uncertain whether such costs will arise.
2. **Special sales**  
If the sale did not proceed, those 2,400 quarters already identified as ‘surplus’ for the sale would be sold in bulk by the Department, at an assumed 60 per cent discount.
3. **Redevelopment income**  
The redevelopment gains that would be realised by the Department, if the estate were managed in-house. This includes ‘marriage value’ (from adding adjacent land and properties to the married quarters sold), that would not be available to the purchaser of the married quarters estate.
4. **Rental proceeds**  
The proceeds from the Department letting empty quarters, pending their disposal.
5. **The Department’s management costs**  
The costs for the Department, including those of the Defence Housing Executive, associated with the management of the quarters and their disposal (in-house) or surrender (under the sale).
6. **Maintenance**  
Maintenance costs for houses underleased by the Department would have been the same had the sale not proceeded; so the appraisal included only the costs of maintaining surplus houses under the in-house management options, until their disposal.
7. **External advisers fees**  
The costs of external advisers involved in identifying surplus quarters and their disposal/surrender.
8. **Residual values**  
The market value of the married quarters still owned and leased back by the Department at the end of the investment appraisal period.
9. **Payment in two tranches**  
This is the value to the Department of the period over which the second tranche of the sale price was deferred.
10. **Rents**  
In their investment appraisal, the Department projected a range of occupancy levels for the married quarters included in the sale (Figure 13 in the main Report). These occupancy assumptions affect not only the rents that the Department would pay, but other items in the investment appraisal. For example, a high occupancy of the quarters by the Department would:
-

- 
- reduce the gross value of continued in-house management of the estate - with lower income from selling or letting surplus houses, but a high residual value in the estate from the greater number of properties retained by the Department; and
  - reduce the gross value to the Department of the sale - with a high level of rents paid to the new owner, but lower clawback receipts, tax income and other costs.

For the first 25 years, rents for each site subsume a 58 per cent discount on the aggregate market values of the houses at those sites. The rents paid by the Department will be reassessed after the 25 year point, on an open-market basis but still taking account of features such as the Department's maintenance responsibility and the size of the letting. The Department anticipate a discount of 38 per cent, reflecting bulk for site-wide rents and the Department's covenant; but not the Guaranteed Payments or estate-wide bulk (Box 2 of the main report).

11. **Profit share (clawback)**

The Department's investment appraisal included estimates of the likely value of clawback receipts, including its likely value under different assumptions about future property values and the Department's occupancy of married quarters, which would effect the likely volume of disposals of surplus quarters by the new owners.

12. **Department's third party income**

Under the sale, the income to the Department from letting empty quarters, pending their surrender to the new owners.

13. **Tax**

Tax income to the Exchequer from the new owners. This excludes Corporation Tax because this is subsumed in the 6 per cent Treasury discount rate used in the investment appraisal.

14. **Compensation for underlease renewal**

One of the sensitivity assumptions of the Department's investment appraisal involved the potential difficulty in securing continued underleases by extending the time horizon for the analyses from 25 to 30 years and building in a net cost penalty for sites where the new owners' intention to terminate the underlease could not be defeated.

The sensitivity analysis assumed that this might be the case for five per cent of sites still rented by the Department after 25 years, and that for these the net cost might be the equivalent of 20 times the annual rent for those sites. They considered that, in such an event, this would be the cost of either buying-out the new owners' intention to terminate the underlease, or of securing alternative accommodation and moving to it. The present value of these additional costs, subsumed in the Department's investment appraisal, was £24 million, but was not tailored to different levels of occupancy used in the investment appraisal.

---

## Appendix 6

---

### Clawback provisions

1. This Appendix describes the disposals that trigger the clawback, and the basis of the clawback calculation.

#### Disposals triggering the clawback

2. Disposals covered by the clawback may be physical disposals of the houses, or 'deemed disposals'. Each is triggered under the following circumstances:

##### Physical disposals:

- a) selling properties.
- b) letting properties.
- c) selling options to purchase properties at a later date.

##### "Deemed" disposals:

a) where the equity interest in the ownership of the estate is sold or transferred or reduced by a further issue of equity (for example, through a flotation by the estate owners or by other firms with an equity interest in the owners), so that the proportion of the equity interest held falls below certain triggers:

100%, 90%, 80%, 70%, 60%, 50%, 40%, 30%, 25%.

There are, however, specific **exceptions**. Principally:

- disposal of equity in the Nomura Group or companies with a stake in the Nomura Group, provided the Group's interest in the Annington Group remains the same. This is intended to avoid a takeover of the Nomura Group triggering the clawback.
  - transfers of shares between Annington Group companies which are ultimately wholly-owned by Annington Holdings plc. These would have no real impact on the returns earned by investors in the Annington Group.
  - the transfer of up to 30,000 of the 100,000 original 'warrants' (options to buy equity shares) from Nomura International plc to Blackrock UK Partners, provided this was completed before 1 April 1997 (in the event, just under 25 per cent of the warrants were transferred before 1 April 1997). Such a transfer would have been deemed to be part of the financial structuring of the original purchase of the estate from the Department.
- b) where applications for planning permission are outstanding at the end of the 15 years clawback period. This ensures that the gains on disposal from subsequent planning permissions are covered by the clawback. Planning permissions secured within the 15 year clawback period, however, are not meant to be subject to clawback, and are therefore not 'deemed disposals'.

#### Clawback calculation

3. The basis of the calculation of the clawback is set out opposite.

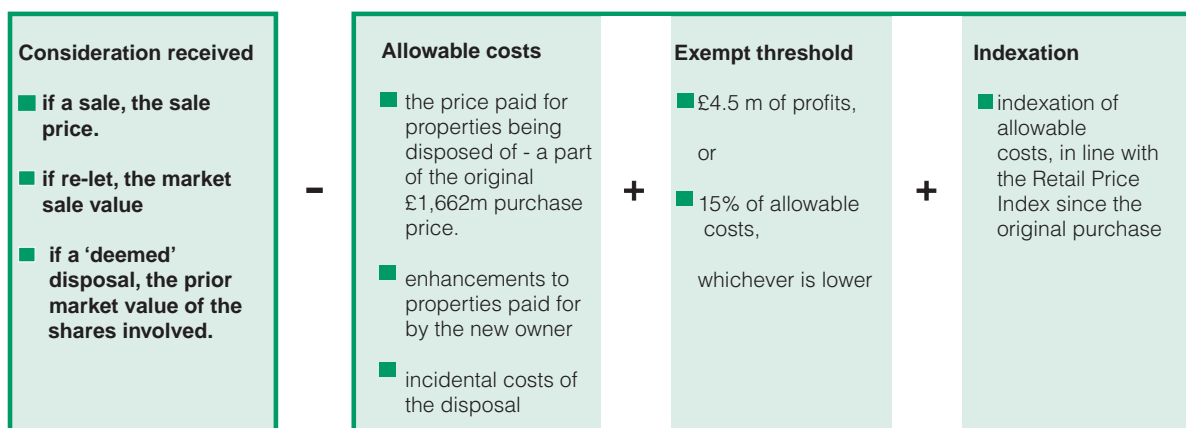


**The Department’s share of net profits on disposals of a “relevant interest”<sup>1</sup> in the estate**

Year		Year		Year	
1	50%	6	25%	11	22%
2	45%	7	25%	12	19%
3	40%	8	25%	13	16%
4	35%	9	25%	14	13%
5	30%	10	25%	15	10%

**The calculation net profits**

Net profits liable to clawback are the product of:



**1. “Relevant interest”**

- ownership, by the Annington Group, of the married quarters properties. A disposal of this interest would involve a sale or lease of houses.
- Annington Group companies.
- a person or company owning 25 per cent or more of the equity of an Annington Group company (or the group as a whole); other persons or companies in turn owning 25 per cent or more of these owners; and companies with 25 per cent or more of their equity owned by the Annington Group.
- Any person or company that acquires 66 per cent of the market value of the married quarters estate.

These ‘relevant interests’ are defined in this way to capture for clawback increases in property values that are transferred, through equity share transfers or sales, to companies connected with the Annington Group, or to companies specially set up to accumulate these profits.