National Audit Office

Report
by the Comptroller
and Auditor General

Ministry of Defence

The Ministry of Defence's arrangement with Annington Property Limited

HC 762 SESSION 2017–2019 30 JANUARY 2018

Key facts

£2.2bn–£4.2bn

is the amount by which the Ministry of Defence (the Department) would be better off if it had retained the estate (December 2016 prices)

£250m

is the current annual downward adjustment received by the Department on market rent

2021

is the point beyond which any continuing adjustment to the rent will depend on negotiation

The deal

55,000	number of retained housing units sold to Annington in 1996 on 770 sites, as well as over 2,000 surplus units
200 years	length of underleases on properties retained by the Department
58%	downward adjustment on market rent for first 25 years, worth around £4 billion to date to the Department

Since the deal

39,000	housing units retained by the Department in December 2016 at over 500 sites
19%	vacancy rate on the Annington estate
£11,369	is the average amount per unit that the Department has paid in 'dilapidations' to Annington since 2004
£7.3 billion	is the gross fair value of the Annington estate stated in its accounts

The future

Unclear	future rents

Summary

Key findings

1 The Ministry of Defence (the Department) aims to provide its service personnel and their families with subsidised accommodation that meets the government's Decent Homes Standard for public housing. This reflects the need for service personnel to be mobile or work in remote locations. Subsidised accommodation is considered a fundamental part of the overall remuneration package for those in the armed forces, and plays a crucial role in retaining them in the services. It can take the form of either an appropriate allowances package or publicly provided family or single accommodation.

2 In 1996, the Department sold 999-year head leases on some 55,000 housing units that it wished to retain on its married quarters estate (the Annington Estate), as well as over 2,000 surplus properties. It then rented them back on 200-year underleases from Annington Property Limited (Annington). The Department originally secured a 58% adjustment to open market rents on properties during the first 25 years of the contract.[1] The adjustment is currently worth £250 million per year. From 2021, the rents will be reviewed on a site-by-site basis. The extent of any continuing adjustment to normal market rents from then on is unclear. The Department considers that there are a number of factors that justify a significant continuing downward adjustment, a view with which Annington disagrees, having consistently stated it believes rents will go up. In parallel with these negotiations, the Department is developing a Future Accommodation Model (FAM) for service personnel. Several of our recent reports have drawn attention to affordability issues within the Department's overall budget. How these issues are resolved will affect the Department's ability to carry out its future spending plans.

1 In our 1997 report on the sale, Comptroller and Auditor General, Ministry of Defence, *The Sale of the Married Quarters Estate*, Session 1997-98, HC 239, National Audit Office, August 1997, the adjustment was referred to as a discount.

3 In 1997, we reported on the bulk sale and leaseback of the estate. The Department's main aims in selling the estate were to transfer ownership of the bulk of the married quarters estate in England and Wales to the private sector; secure funds for upgrade work; and improve management of the estate. We drew attention to the fact that, while the sale and leaseback appeared to satisfy the Department's immediate objectives, the sale price was lower than the value of retaining the estate, and the Department retained important responsibilities for managing it. Given the importance of housing to service personnel and the significance of the forthcoming rent renegotiations for the Department's overall budget, we have returned to examine the Department's management of the contract, and whether the contract is set up to achieve value for money in the future. In particular, this report examines:

- the value for money of the original sale (Part Two);
- whether the Department has secured the best value for money from the deal in the past 21 years (Part Three); and
- the Department's prospects for achieving value for money in the future (Part Four).

Our audit methodology is set out in Appendix One. Given that some of the events described in the report date back to 1996, in places we have relied on published information and the remaining departmental documents.

The original value for money of the sale

4 **The Department committed itself to a deal requiring up to 200 years of rental payments in return for an upfront cash sum, having assessed that it would be cheaper to retain ownership.** Ministers were committed to a bulk sale and leaseback of properties, although the Department had calculated that retaining ownership would be cheaper. Although the £1.66 billion sale price was above the Department's external valuations of the estate, it was between £77 million and £139 million below its valuation for retaining the estate (between £1.74 billion and £1.8 billion at 1996 prices). We reported in 1997 that the Department's decision to proceed with the sale rested, ultimately, on securing a competitive price for assets that the Department decided it did not need to own. The Department also considered other proposed policy benefits such as releasing money to upgrade the estate and providing an incentive to dispose of properties faster. The Department can terminate the agreement in whole or part by giving six months' notice and by subsequently settling dilapidations claims (paragraphs 2.2 to 2.8 and Figure 5).

5 **House price increases since the sale – the scale of which could not have been foreseen at the time of the deal – mean the Department is £2.2 billion to £4.2 billion worse off over the first 21 years of the contract than if it had retained the estate, depending on the assumptions used.** Much of the loss is due to house price rises since the deal, the scale of which the Department could not have predicted. However, the Department's own assumptions were over-cautious in the context of 1996. The Department's preferred business case model assumed house price increases of 1% per year excluding inflation, which, because the Department sold at the bottom of the market, implied that house prices rises would never return to the existing long-term trend. In the event, house prices increased by 3.9% a year (excluding inflation), significantly more than could have been predicted even with more accurate modelling. The combined effect of higher-than-expected rental payments and the loss of the benefit from the rise in house prices, net of the proceeds from the original sale, equates to a loss on the sale and lease back of £2.2 billion to £4.2 billion so far, depending on the method of discounting costs over time. These numbers will increase with any further year of above general inflation increases in rents and house prices over the remainder of the 200-year deal (paragraphs 2.9 to 2.14 and Figures 7 to 10).

6 **Returns to Annington's owners have been significant.** The main external risks to Annington from the deal were significant falls in house prices and rents. Our 1997 report found that the Department expected Annington to achieve an annual rate of return of 9.7% including inflation. We now calculate that rising rents and house prices mean the actual rate of return was 13.4% for the period from the sale to the end of March 2017. Annington's investors, Nomura to 2012, and, thereafter, the current owners, a number of investors including Terra Firma Special Opportunities Funds I and II L.P., have made much greater returns. To realise these profits, Annington must be able to sell the properties at their current valuation in the company's accounts (a gross £7.3 billion in 2016-17) (paragraphs 2.17 to 2.21).

The value the Department has achieved from the deal over the last 21 years

7 **The Department has not properly managed the risks and responsibilities that it retained.** In order to avoid prompting disproportionately poorer bids, the Department retained a number of risks and responsibilities that a landlord would normally manage in residential leases. The current rent is calculated by applying a downward adjustment of 58% to the open market rent to reflect these costs, including that it pays for empty properties and all maintenance costs. This also takes account of the size of the estate and the additional security of government-backed payments. The Department has not managed these risks well.

- **Maintenance and quality of the estate**

  Unusually, the Department retained responsibility for maintaining the properties when it sold them. We have previously reported on issues concerning the maintenance of the estate, which indicated it had not been kept in good repair.[2] It has cost the Department an average of £11,369 per unit to bring properties handed back to Annington since 2004 up to the standard required for surrender (paragraphs 3.5 to 3.6 and 3.9).

- **Vacancy rates**

  The current vacancy rate on the Annington estate is 19%. This is almost twice the Department's target and similar to the rate before the deal. The sale was intended to provide an incentive for the Department to dispose of surplus properties more quickly. Most of the properties surrendered to Annington were declared surplus by the Department before 2004. The size of the estate has not fallen in line with recent reductions in the armed forces, although some vacant properties are being maintained to accommodate troops returning from Germany (paragraph 3.10 and Figure 16).[3]

- **Management costs**

  The Department has not kept track of the extent and reasonableness of the costs of carrying out its management responsibilities for the estate (paragraphs 3.3 to 3.4 and 3.7 to 3.9, and Figures 13 and 15).

8 **The Department and Annington have not worked together to generate greater value from the estate.** One justification for the sale was the possibility of future opportunities and efficiencies resulting from partnership with the new owner. However, the Department told us that partnership was not an option. For example, it believed that Annington lacked the ability to maintain the estate at the time of letting the maintenance contract. Beyond the agreement to share in the proceeds from the sale of surplus properties, which ended in 2011, there has been little collaboration in developing subsequent deals. Annington told us that maintaining its contractual relationship with the Department has been difficult, as a succession of different responsible bodies, and regular changes in senior-level personnel, had left the Department with significant gaps in its corporate memory (paragraph 3.11 and Figures 15 and 17).

2 Comptroller and Auditor General, Ministry of Defence, *Delivering the defence estate*, Session 2016-17, HC 782, National Audit Office, November 2016; Ministry of Defence, *Memorandum: Service Family Accommodation update*, January 2017.

3 Comptroller and Auditor General, Ministry of Defence, *A defence estate of the right size to meet operational needs*, Session 2010-11, HC 70, National Audit Office, July 2010.

The Department's prospects of achieving value for money in the future

9 It is unclear whether future rents will properly take into account the risks and costs that the Department carries. The valuations of the estate included in Annington's accounts since the deal have been based on its assumption that rents will rise beyond 2021, when rents will be reviewed on all properties. However, the Department considers that there are several factors that justify a significant continuing downward adjustment to rents after 2021, beyond those recognised at the time of the sale. It is possible that the rent reviews will be subject to a formal arbitration process for each of the 511 sites (paragraphs 4.2 to 4.4 and Figure 18).

10 If the Department does not maintain the existing rental adjustment beyond 2021, its annual costs could increase significantly. If the adjustment were to reduce to 38%, for example, its annual rental payments would increase by £84 million. At this point, the deal will still have up to 175 years to run, depending on when the Department considers that it no longer requires the estate and surrenders it (paragraph 4.9 and Figure 19).

11 The Department has started to prepare for the formal site-by-site rent reviews but has not yet begun contingency planning or assessed what alternatives it has on a site-by-site basis. In September 2017, the Department advised Annington that it disagreed with its position that the rents would rise significantly and wanted an agreement in principle to an adjustment. It has engaged surveyors, financial advisers and lawyers to help it prepare for the possibility of a formal arbitration process if initial negotiations do not produce an agreement. The Department must plan for a range of possible outcomes, and its consultants have begun to collect and process the information necessary. The Department faces a significant challenge in gathering the information it needs within the timetable for negotiations, to allow it to choose what to do with each site (paragraphs 4.2 to 4.9).

12 The timetable for developing the Department's wider estate strategies and the timetable for the Annington rent reviews are misaligned. The Department's FAM is intended to provide personnel with more flexible accommodation options. It plans to pilot new arrangements in 2018. However, under current plans, the Department will not decide whether or when to roll out the FAM until negotiations on sites are already underway. This will affect its ability to develop negotiating strategies for these sites. Conversely, the affordability of the FAM business case assumes that the current rent adjustment on the Annington estate will continue, so plans will be implemented with uncertainty about their costs (paragraphs 4.10 to 4.12 and Figure 20).

13 The Department has spent the last few months building the team it needs to conduct negotiations on an equal footing with Annington. The Department formally set out its opening negotiating position to Annington in September 2017. It has engaged UK Government Investments to supply strategic and negotiating support to a core team in the Defence Infrastructure Organisation (DIO), which is leading the negotiations. DIO staff, along with legal and property consultants, began background work on the negotiations in 2015. In September 2017, the Department announced that it intended to terminate its contract with Capita by 2019. Under this contract, Capita supplied a small number of key staff to the DIO through its lead role in the consortium as the DIO's lead Strategic Business Partner. The Department told us that this will not impact on the negotiations. If and when site-by-site reviews begin, it will need significantly more staff. The Department should note the example of the Department for Work & Pensions (DWP), which is currently re-letting its leases for managing its office estate. The DWP found it necessary to significantly increase staff numbers to collate information on its estate (paragraphs 4.13 to 4.16).

Conclusion on value for money

14 When the Department sold the majority of its married quarters estate to Annington Property Limited it committed itself to paying rental bills of hundreds of millions of pounds each year, stretching into the foreseeable future. The deal did not generate the improvements in the management of the estate that the families who live in the properties would have hoped for. Meanwhile, the steep increase in house prices means that the Department has lost out on billions of pounds worth of increases in asset values, while Annington has made a significantly higher return on its investment than expected.

15 The Department cannot change the past, but achieving value for money in the future will be closely linked to the level of ongoing adjustment in the rents paid on these properties. The Department must be ready and able to conduct rent negotiations on an equal footing with Annington, based on proper resourcing, accurate information and a robust negotiating strategy. It cannot do this effectively if it does not have more clarity about its options for the future of service family accommodation. The Department faces a considerable challenge in gearing up for these negotiations. Many billions of pounds are at stake, and were the Department not to be ready when detailed negotiations start it could sacrifice very significant public value.

Recommendations

For the Department

a **The Department and HM Treasury should incorporate the Annington rent negotiations into the Government Major Projects Portfolio.** This is a highly complex project worth billions of pounds. The programme should set up appropriate governance and assurance accordingly. The Cabinet Office should be monitoring its progress in the same way as, for example, it is monitoring the Department for Work & Pensions' office estate renegotiation.

b **The Department needs to align, as far as possible, its FAM timetable with its Annington rent negotiations.** To inform the FAM the Department needs to assess the demand for each site so that it knows which sites will be of continuing importance and what their rent will be. It should bring forward decisions about the FAM as far as possible, and use realistic scenarios, based on its work to date, in its strategies for the negotiating team about key sites.

c **The Department should develop alternative strategies for each site to a timescale that supports the negotiating team and is based on comprehensive information.** If negotiations do not go well, the Department needs plans in place that set out which sites it can surrender immediately, where it needs to construct alternative provision, and where it can use existing private rental markets. The negotiating team cannot wait until 2021 for this information.

d **The Department's board should satisfy itself that people and funding are in place to properly resource each stage of the negotiations.** The team leading the negotiations with Annington should be properly resourced to prepare for, and conduct, the negotiations. This reflects the fact that the amounts of money at stake in the long-term far outweigh any additional short-term costs.

For HM Treasury and Cabinet Office to share across government

e **Departments should be required to demonstrate that contracts are affordable in the longer term.** The Department surrendered significant future value for an upfront cash receipt. This appears to have happened in part because of net present value calculations, such that it discounted future rent payments and the value of the properties to a trivial amount. However, for the Department now, these rent payments present a considerable challenge. Accounting officers should not rely solely on net present value calculations that provide only one source of information about a project. Guidance should require business cases to set out how contracts will behave under different scenarios.

f **Cabinet Office should distribute the lessons from this deal throughout the commercial community.** The Department has so far failed to follow best practice in commercial management of contracts throughout the lifecycle of this contract. We set out some of the lessons in our conclusions in Appendix One.