National Audit Office

Report
by the Comptroller
and Auditor General

Ministry of Defence

The Ministry of Defence's arrangement with Annington Property Limited

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Report by the Comptroller and Auditor General

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Sir Amyas Morse KCB
Comptroller and Auditor General
National Audit Office

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This report looks at the sale and leaseback arrangement the Ministry of Defence made with Annington Property Limited in 1996, what happened subsequently and future implications of the deal.

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Contents

The National Audit Office study team consisted of:
Gregor Botlik, Jeremy Gostick and David Molony, under the direction of Jeremy Lonsdale and Joshua Reddaway.

This report can be found on the National Audit Office website at www.nao.org.uk

For further information about the National Audit Office please contact:

National Audit Office
Press Office
157–197 Buckingham Palace Road
Victoria
London
SW1W 9SP

Tel: 020 7798 7400

Enquiries: www.nao.org.uk/contact-us

Website: www.nao.org.uk

Twitter: @NAOorguk

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.

Part One

Background

Service family accommodation

1.1 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 a need for service personnel to be mobile or work in remote locations. Subsidised accommodation is considered a fundamental part of the overall 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. The Armed Forces Pay Review Body, which provides independent advice on the remuneration and charges for the armed forces, has found that service families greatly value subsidised accommodation.

The sale and leaseback of service family accommodation

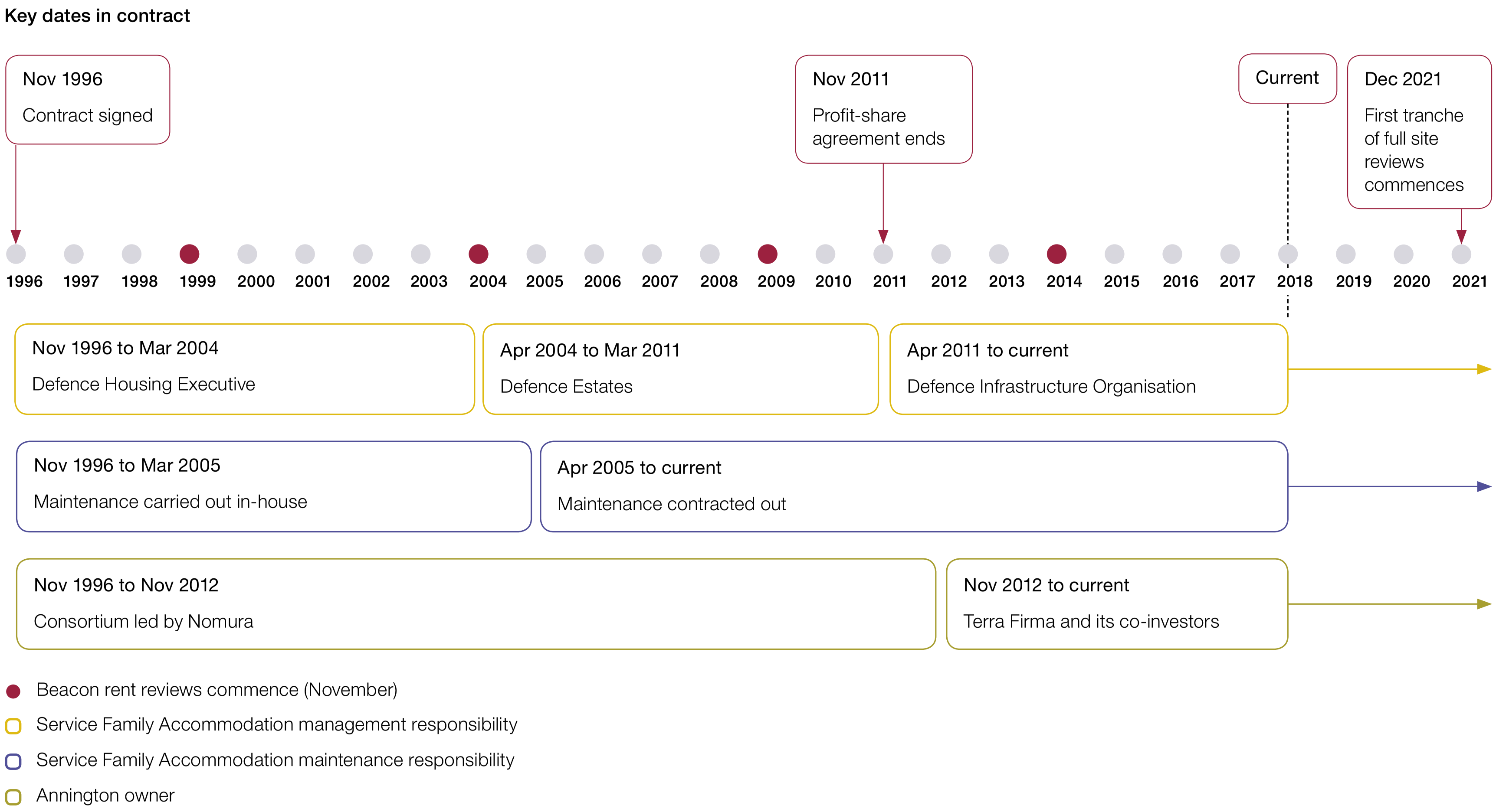
1.2 In 1996, the Department sold 999-year head leases on some 55,000 housing units that it owned. The Department then rented them back on 200-year underleases from Annington Property Limited (Annington). **Figure 1** shows the timeline of key dates and events since the sale, including the changes in private sector ownership.

1.3 The sale represented 80% of the Department's service family accommodation. It excluded properties in Northern Ireland and Scotland for legal and operational reasons, as well as 6,300 properties in England and Wales, including 3,000 provided to United States visiting forces and 1,500 already being sold or leased by the Department.

1.4 The relationship between Annington as landlord and the Department as tenant was set out in the leases, subject to a master agreement that governs the overall relationship, the terms of which were set down by the Department. The structure of the deal is summarised in **Figure 2** on page 14. The Department retained the responsibility for managing and maintaining the properties it continues to occupy.

Figure 1

Timeline of events relating to service family accommodation sold to Annington Property Limited



Notes

1 Beacon rent reviews are five-yearly rent reviews conducted on sites based on the valuation for a benchmark 'beacon' house at each site. The open market rental value is then reduced by 58%.

2 Until 2011, the taxpayer benefited from an agreement with Annington to share the profits from the sale of surplus properties.

Source: National Audit Office

Figure 2

Contract structure of the Ministry of Defence's arrangement with Annington Property Limited

The terms of the current arrangement may change from 2021

Deal structure 1996 to 2021

1996 Married quarters estate – over 57,000 units including surplus units

Sale and purchase agreement

- Annington pays £1.66 billion
- Created, and enabled the creation of, new leases and other contracts

Lease documentation

Freeholds

- Retained by MoD
- 770 sites, 55,000 units
- Enables covenants on the land

770 Headleases

- Annington is tenant
- 999-year leases

770 Underleases

- MoD is a tenant to Annington
- MoD can surrender each unit separately to Annington with 6 months' notice
- Landlord can terminate each unit for redevelopment or do a swap for comparable/alternative land at years 25 to 28, then at 15-year intervals
- MoD pays rent to Annington (£110m in 1996), with a 58% adjustment to market rents for residential properties
- Rents are reviewed every 5 years by benchmarking a 'beacon' example property to market rents and applying a 58% reduction

MoD sublets accommodation to service personnel

- Service personnel pay subsidised rents to MoD

Other contracts/features of the deal

Over 2,000 surplus units sold to Annington

Guaranteed Minimum rent

- Guaranteed minimum rents to Annington (expires in December 2021)

Utilities agreement

- For MoD's provision of, for example, power and sewage

Profit Share Agreement

- Taxpayer received a share of Annington's profit on selling units surrendered by MoD
- Expired in 2011
- Delivered cash payments of £160m to MoD over 15 years

Guidance notes

- Protocols for ways of working

Current position (2018)

Following MoD's surrender of units it has:

- 39,000 units
- 511 sites remaining
- Rent payable for 2016 was £178m after 58% adjustment.

Changes to structure from 2021

Site-by-site reviews of rent

Site review at a whole-of-site level to include:

- Removal of the existing 58% adjustment. Continuing adjustment is subject to negotiation and surveyors' valuations
- Valuation by surveyor
- Assumptions and disregards change from Beacon reviews

Utilities agreement

- Ceases to have effect in phases (through 2021 to 2024)

Note

1 Under the terms of the deal the Department retains all management and maintenance responsibilities.

Source: Ministry of Defence

Accommodation available to service personnel today and future plans

1.5 Currently, three quarters of regular service personnel live in service accommodation during the working week. This consists of around 50,000 units for service families and 126,000 single living accommodation units, the vast majority of which are in England (**Figure 3**). Half of all personnel own their own home, but given the need for mobility, with 46% of personnel moving more than three times in the last five years, it is impractical for many home-owning personnel to commute to work.

1.6 The type of subsidised accommodation available to service families ranges from flats to large detached houses, although most are two- to three-bedroom semi-detached or terraced houses. The proportion of service personnel living in service family accommodation varies from 39% in the Army to 15% in the Royal Marines.

1.7 Since the sale of 55,000 housing units in 1996, the Department has handed back to Annington over 16,000 empty properties that it no longer requires. **Figure 4** overleaf shows the distribution across England and Wales of the properties sold to Annington, and those remaining at the end of 2016. This shows that the Department's housing is increasingly concentrated in south central England.

Figure 3
Service personnel accommodation in the UK

Service accommodation consists of almost 50,000 units for service families, of which 79% is the Annington estate, and 126,000 single living units

Units of Service Family Accommodation	
Owned by Annington	38,979
Not owned by Annington	10,569
	49,548
Units of Single Living Accommodation	**126,000**
Total living accommodation across the UK	**175,548**

Notes

1 Not all service accommodation available is occupied.

2 Service family accommodation is available to service personnel aged 18 and over; married or in a civil partnership or who have permanent custody of children; and have at least six months to serve.

Source: Ministry of Defence and Parliamentary Question 69280, 3 April 2017

Figure 4

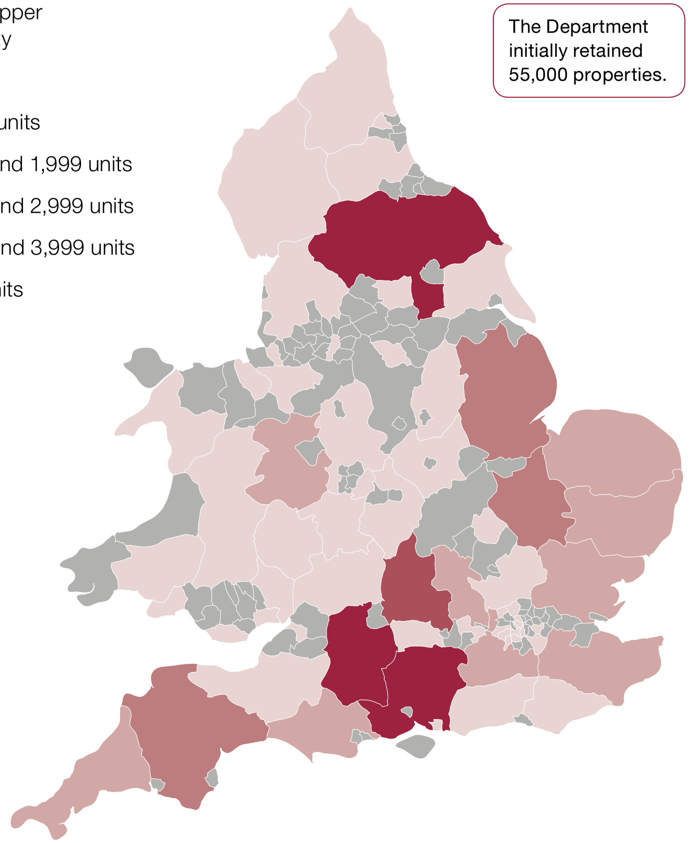
Scale and distribution of service family accommodation sold to Annington

The Department sold 55,000 housing units at 770 sites to Annington, and leased them back. It also sold to them more than 2,000 surplus units. At the end of 2016 it retained 39,000 units on 511 sites

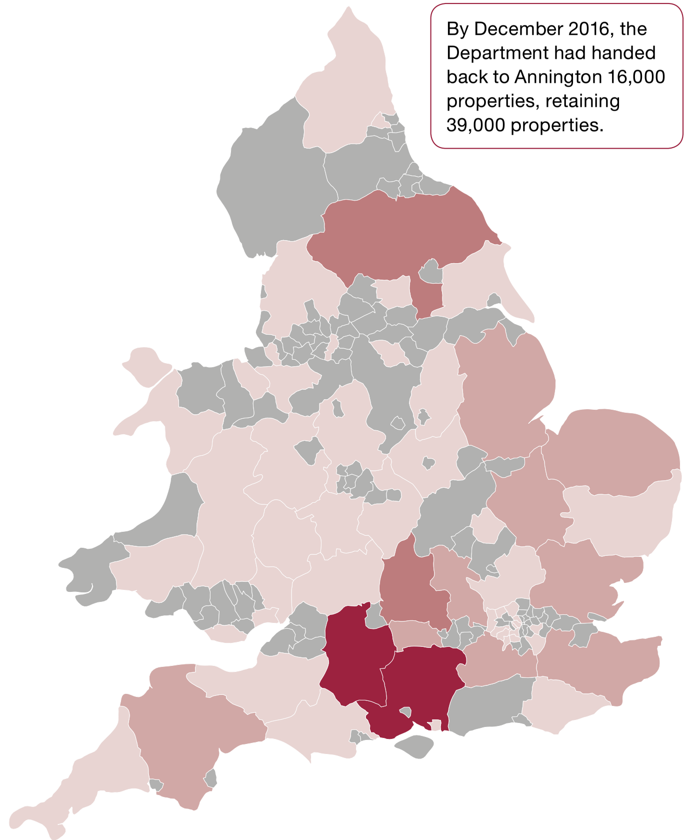
Sold to Annington
November 1996

Number of units in upper or single tier authority

- No units
- Less than 1,000 units
- Between 1,000 and 1,999 units
- Between 2,000 and 2,999 units
- Between 3,000 and 3,999 units
- 4,000 or more units



Retained by the Department
December 2016



Note

1 The types of units range from flats to large detached houses.

Source: National Audit Office based on Annington Property Limited data

1.8 Evidence from annual surveys of service personnel suggest that many have rising expectations of their accommodation needs. Armed forces personnel have expressed a preference for greater choice of housing and for support in buying their own home.[4] The Department is now developing a Future Accommodation Model (FAM) (see paragraph 4.10). Decisions regarding the Annington estate will affect the affordability of the Department's FAM.

1.9 This report covers:

- The value for money of the original sale (Part Two);
- The value achieved from the deal in the last 21 years (Part Three); and
- The Department's prospects for achieving value for money in the future (Part Four).

4 Ministry of Defence, *Future Accommodation Model Survey*, March 2017.

Part Two

The value for money of the original sale

2.1 This part of the report looks at:

- why the Ministry of Defence (the Department) sold the estate and whether the sale met its objectives;
- projected proceeds and costs over time, and how these compare with the actual costs since the sale;
- why the costs to the Department have been much higher than predicted, and whether this was foreseeable; and
- how Annington Property Limited (Annington) and its investors have benefited from the sale.

Why the Department sold the estate

2.2 In 1992, the Department set up a Housing Task Force which concluded that the quality of service family accommodation was inadequate and that the accommodation was managed inefficiently. It recommended setting up a housing trust to improve the management of the Department's accommodation. However, the Central Statistical Office (now the Office for National Statistics) did not accept this as a genuine transfer of risk to the private sector, and the proposals were abandoned in August 1994.

2.3 In November 1994, the Department appointed advisers to develop plans for a sale to the private sector. The options considered were:

- a bulk sale;
- a piecemeal sale, involving targeted sales of parts of the estate; and
- retaining the estate – which was the main comparator.

2.4 In November 1995, the Department started a bulk sale of most of its married quarters estate through a competitive process, which attracted 19 formal bidders. The Department’s modelling indicated that retaining the estate in-house would provide better value than a sale. In May 1996, the Department’s accounting officer confirmed to ministers that ‘the general messages arising from the appraisal’ were ‘robust’, subject to an ‘unquantifiable margin of error arising from the results’, and asked ministers to consider this carefully. He advised that the ‘methodology for judging value for money was not straightforward’. He added that if ministers reaffirmed their commitment to the sale, then achieving a price that reflected the public interest would depend on ‘a value for money assessment that sale proceeds have been maximised through effective competition and are fair in relation to a market valuation of the estate.’

What the sale aimed to achieve

2.5 The Department set four objectives for the sale as well as six underlying rationales. It was satisfied that the sale had either met its objectives or could meet them in the short term. However, the objectives were limited in scope and, in particular, did not cover the most cost-effective way of continuing to deliver service family accommodation. In addition, the sale did not fully satisfy the rationales given at the time (**Figure 5** on pages 20 and 21).

The proceeds of the sale and subsequent costs to the Department

The proceeds of the sale, compared with pre-sale valuations

2.6 The sale achieved proceeds of £1.66 billion, which was higher than the Department’s valuation for a bulk sale of £1.48 billion. To achieve this, the Department invited shortlisted bidders to submit best and final offers against the terms and conditions it had set. These terms included a 58% downward rental adjustment for the first 25 years. The Department did not set a reserve price for the sale. It then selected Annington, after evaluating each offer against four criteria:

- price;
- readiness to accept the Department’s terms and conditions;
- the solidity of the bidder and its financing plans; and
- prospects for future relations with the purchaser as landlord and neighbour.

Figure 5

How well the sale addressed the Department's stated objectives and rationales for the deal at the time

The Department's objectives and rationales set out in 1996 did not address the long-term financial implications of the deal

The Department's objectives for the sale	The Department's rationales for the sale	Objective and rationale met?	Explanation
Objective 1 Achieve a competitive sale.	Rationale 1 The Department's assessment that, within the sale option, the price was the best that a good competition could extract from the market.	Fully	Although, the price achieved was below the Department's estimated valuations of retaining the estate, the sale followed a competitive bidding process.
Objective 2 Transfer ownership to the private sector of 80% of the married quarters estate.	Rationale 2 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.	Partly	The Department transferred ownership to the private sector, but: • the Department retained most of the risks associated with ownership including management and maintenance (para 3.2).
Objective 3 Provide funds to upgrade below-standard quarters over the five to seven years following the sale.	Rationale 3 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.	Partly	Of the sale proceeds, £100 million (para 2.8) was released for accommodation upgrades over the first five to seven years of the deal, but: • the upgrade funds represented only 6.25% of sales proceeds; and • no upgrade funds were allocated for the remainder of the 200-year deal.
Objective 4 Improve management of the estate, providing the Department with an incentive to identify and surrender surpluses.	Rationale 4 The new owners would be better placed to manage the properties that fall surplus, and release them for use by others.	Partly	The profit sharing agreement (para 3.8) offered an incentive to hand back properties in the first 15 years after the deal. Annington quickly sold on to private sector buyers 16,000 surplus properties released to it by the Department, but: • the agreement has now ended; and • 19% of Annington owned properties retained by the Department are empty against the Department's 10% target.

Figure 5 *continued*

How well the sale addressed the Department's stated objectives and rationales for the deal at the time

The Department's objectives and rationales set out in 1996 did not address the long-term financial implications of the deal

The Department's objectives for the sale	The Department's rationales for the sale	Objective and rationale met?	Explanation
Objective 4 (continued) Improve management of the estate, providing the Department with an incentive to identify and surrender surpluses.	Rationale 5 The possibility of future opportunities and efficiencies from partnership with the new owner.	No	• The Department and Annington have not worked together to generate greater value from the estate (paras 3.7 to 3.11).
	Rationale 6 The understanding of, and sensitivity to, the services' concerns about the management of the estate which Annington had shown.	Partly	• Annington set up the Annington Trust "for the benefits of service families living on the patch". Since 1996, the Trust has donated £649,927 to 466 military causes and charities. • Annington offers discounts for service and ex-service personnel on surplus properties sold by Annington, taking account of market factors and length of service. • The Department's original proposals allowed the new owner to propose housing exchange 'swaps' if it wished to secure vacant possession of particular sites. Annington agreed to defer 'swaps' until 2021, recognising service family concerns raised by the Army Families Federation and Federation of RAF Wives before the sale. There is no agreement about arrangements beyond 2021.

Notes

1 The four objectives are taken from our 1997 report, Comptroller and Auditor General, Ministry of Defence, *The Sale of the Married Quarters Estate*, Session 1997-98, HC 239, National Audit Office, August 1997.

2 Objective 4 relates to three rationales.

Source: National Audit Office

2.7 The sale price was between £77 million (4%) and £139 million (8%) below the Department's base case valuations for retaining the estate (**Figure 6**). The price achieved was, however, in line with the indicative shortlisted bids that ministers had considered. The Department received advice from the Treasury Officer of Accounts that, in the context of ministers' decision to sell, they did not need to have regard to the in-house comparator.

2.8 HM Treasury agreed to make available to the Department £100 million of the proceeds to fund a programme of improvements across the whole estate over the five to seven years following the sale. HM Treasury told the Department that future budgets would include provision for rental payments.

Figure 6

Sale proceeds compared to pre-sale valuations

Sale proceeds exceeded the estimated value of a sale, but were below the valuation of retaining the estate

	1996 prices (£m)	December 2016 prices (£m)
Sale proceeds		
Sale proceeds	1,662	2,408
Estimated values of options before the sale		
Independent valuations:		
• Estimated value of bulk sale (no vacant possession)	1,480	2,146
• Piecemeal sale option (full vacant possession)	1,820	2,636
In-house valuations:		
• Retention of the estate (base case comparator option – modelled for 25 and 30 years)	1,739–1,801	2,519–2,608
• Retention of the estate (average of alternative scenarios – modelled for 25 and 30 years)	1,712–1,974	2,480–2,859

Notes

1 The Department did not consider that vacant possession was an appropriate benchmark since the housing was largely in continuing occupation.

2 A valuation for a piecemeal sale without full vacant possession had been commissioned but was not yet available.

3 Using ranges is standard practice when valuing long-term deals due to the greater uncertainties involved in predicting future events.

Source: National Audit Office analysis of Ministry of Defence data

The actual cost to the Department since 1996

2.9 At the time of the sale there was no consensus on how to model the costs. The policy was developed by officials in the Department and HM Treasury, advisers, ministers and senior officers. The Department's post-project evaluation stated that in many cases assumptions modelled were "compromises between two extreme views" arising from deep philosophical differences between the parties interested in the deal. The Department's modelling of future cash flows required realistic assumptions to support departmental decision-making. Although the Department was leasing back the properties for 200 years from Annington, its modelling only covered the first 25 to 30 years. The Department can surrender the estate to Annington, in whole or part, giving six months' notice and by subsequently settling dilapidations claims to bring the properties up to the required standard for surrender.

2.10 The costs would be modelled differently today. The Department's view at the time was that the net present value of costs beyond the first 25 to 30 years would have minimal impact on the overall calculation.[5] Future costs were discounted at an annual real rate of 6%, as in HM Treasury guidance, which discounted costs in the latter part of the period to negligible levels. Using this, the Department's business case forecast a loss of £77 million to 2016 (£113 million at December 2016 prices). We calculate that the loss has been £1.49 billion (£2.16 billion at December 2016 prices) (**Figure 7**) repeating the methodology that the Department used in 1996.

2.11 Current HM Treasury guidance sets a real discount rate of 3.5%, while for very long-term contracts the rate should reduce over time. The effect of this would be to give more prominence to costs over the whole life of the contract than would have been the case in 1996. Using this assumption, we calculate that the loss could be as high as £4.17 billion over the first 21 years of the deal.

Figure 7

Projected and actual losses suffered by the Department over the first 21 years of the deal

Actual losses are much larger than predicted in 1996

Comment	1996 business case (£m) (1996 discount rate[1])	December 2016 prices (£m) (1996 discount rate[1])	December 2016 prices (£m) (current discount rate[1])
Loss estimated in Department's model – (difference between present value of sale price and business case 'in-house option')	77	113	N/A
Actual loss – (difference between present value of sale price and actual outcome)	1,492	2,160	4,170

Notes

1 The discount rate is the rate at which costs are discounted over time. HM Treasury guidance at the time of the deal recommended a rate of 6%. HM Treasury guidance since 2003 recommends 3.5%.

2 Modelling covered the first 25 years of the deal.

Source: National Audit Office analysis of Ministry of Defence data

5 The net present value is the stream of future costs and benefits discounted for inflation to present day values.

2.12 **Figure 8** shows how initial sales proceeds of £2.4 billion (at December 2016 prices) have become a loss of £2.16 billion to £4.17 billion. The contributory factors are mostly a mixture of cash payments to Annington (overwhelmingly rents) and the opportunity costs to the Department of not benefiting from increases in house prices.

How property prices have increased since the sale

2.13 The Department modelled annual house price increases of 3% (1% above inflation – the 'base case') and 4% (2% above inflation – the 'high growth estimate'), whereas national house prices have instead risen in value by 6.8% annually (3.9% above inflation) (**Figure 9** on page 26). Although the 'base case' estimate reflected the long-term trend of 1% growth above inflation, the Department did not take into account that it was selling at the bottom of the house price cycle. As a result, its 1996 forecast of 1% growth above inflation meant no return to the existing long-term trend, and that under this assumption it would take more than 40 years for house prices to reach 1989 levels, after removing the effects of inflation.

2.14 Most of the aggregate value of the retained Annington estate is located in regions where house prices have increased the most – in particular, London, the South East and the South West. In these areas many properties have increased in value four- and five-fold (**Figure 10** on page 27).

How rent paid by the Department to Annington has changed since the sale

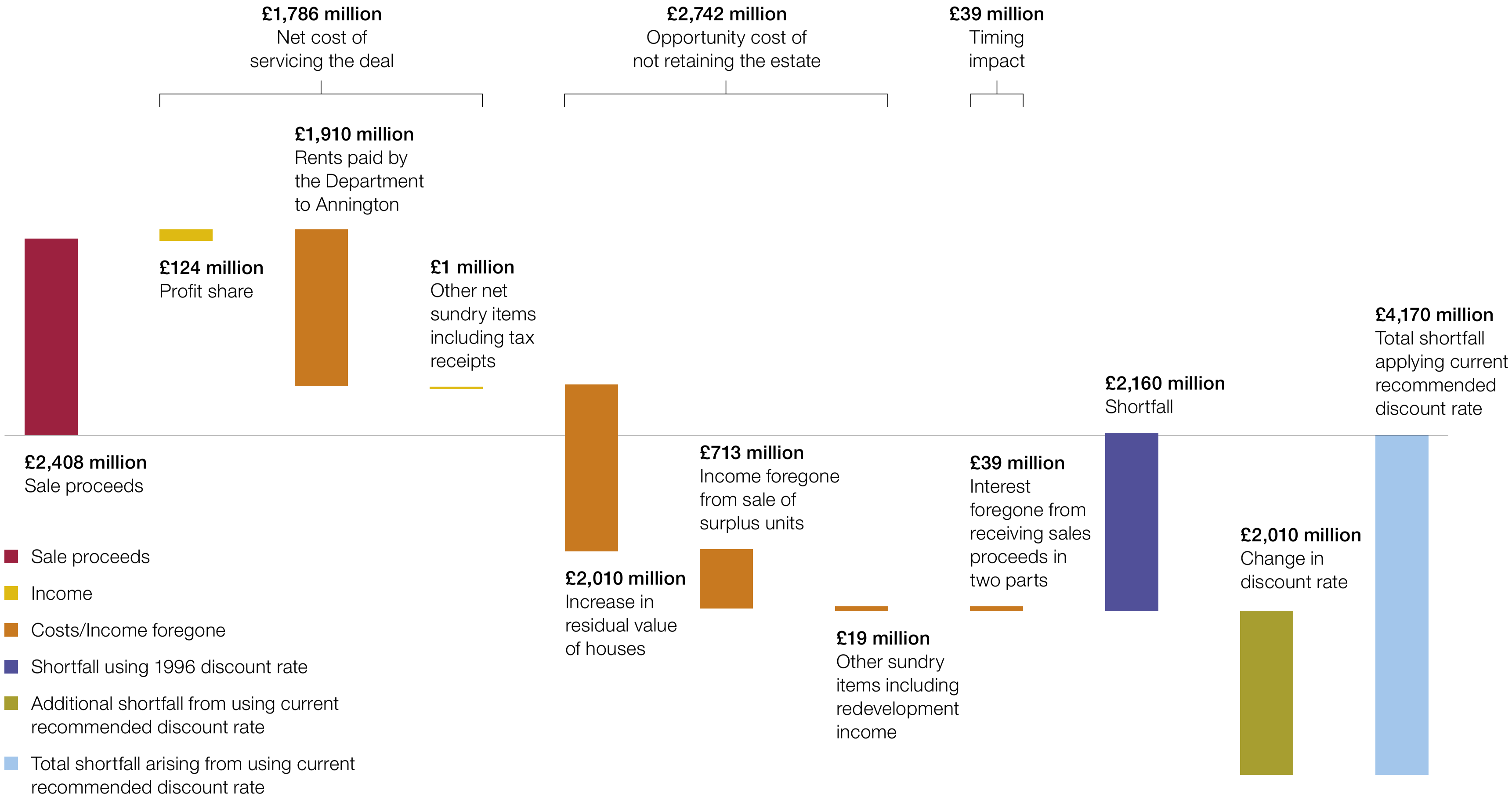
2.15 Despite the retained estate reducing from 55,000 to 39,000 (almost 30%), rents paid by the Department to Annington for properties leased back have increased steadily since the sale (**Figure 11** on page 28). Annual rent paid increased from £111 million in 1997 to £178 million in 2016. Rental payments are net of the 58% rental adjustment due to the Department for the first 25 years of the contract. To date, the Department has benefited from a total rent adjustment in excess of £4 billion.

2.16 Average rents per property increased from £4,797 in 1996 to £10,873 in 2016 before applying the adjustment, and from £2,015 in 1996 to £4,567 in 2016 after applying it. The annual increase in rents during this period was around 4% per year, compared with the Department's 'base case' assumption of 3%.

Figure 8

Reconciliation of sale proceeds to the Department's current financial position regarding the estate (December 2016 prices)

The main contributory elements are a mix of cash costs and opportunity costs from benefits foregone



Notes

1 Costs are the discounted present values at the time of the sale and then uplifted for inflation to December 2016 prices.

2 The Department received a £124 million share of profits on surplus properties handed back to Annington which ended in 2011.

3 Increases in property prices were calculated using the Nationwide national house price index.

4 The total shortfall from application of the current recommended discount rate is explained in Figure 7 on page 23.

Source: National Audit Office

Figure 9

Average real UK property prices since 1971, and the Department's growth projections from 1996, compared to the trend in prices

The Department's 'base case' model (used for the valuations) did not factor in that the sale took place near the bottom of the house price cycle

Note

1 Real long-term house price growth trend is based on real house price growth in the 25 years before the sale.

Source: National Audit Office based on data from Ministry of Defence, Annington and Nationwide

Figure 10

Changes in house prices from 1996 to 2016 in areas with properties comprising the retained estate

Property prices in England and Wales have grown strongly, particularly in the areas where most of the value of the retained estate is concentrated

Notes

1 Includes all entries from the Department's records including non-residential addresses such as garages, substations and playgrounds.

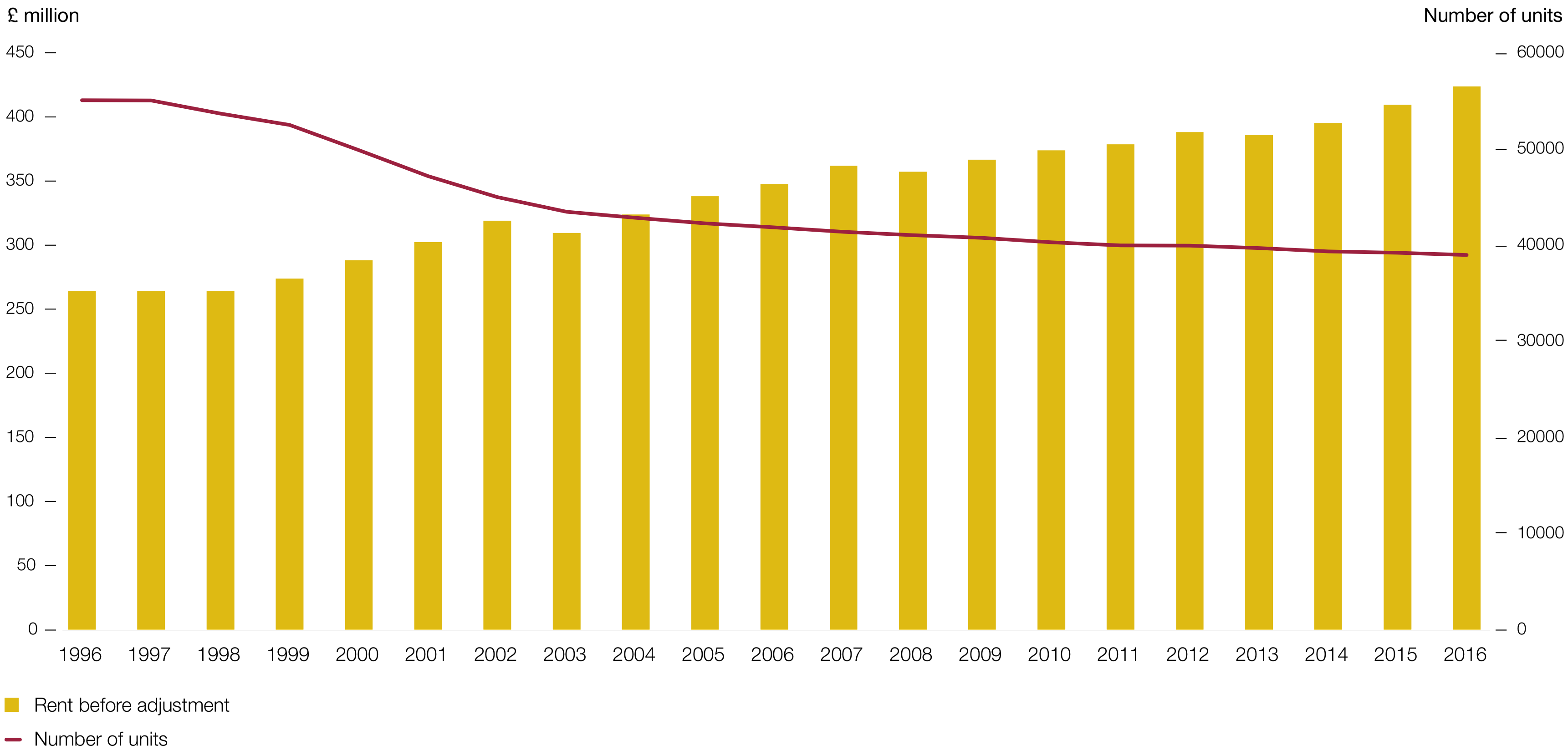
2 House price data taken from the Office for National Statistics' house price statistics for small areas in England and Wales. Property prices are calculated at the middle super output areas level.

Source: National Audit Office based on Ministry of Defence post code data of properties retained at July 2017. Portfolio valuation based on Annington's calculation

Figure 11

Annual rent payable by the Department to Annington before adjustment and number of properties retained

The Department's rent payments continue to increase despite a 29% fall in the number of retained properties



Notes

1 Retained properties fell 29% from 55,000 in 1996 to 39,000 in 2016.

2 All figures are for year to 31 December and include rent payable at the year to date in cash terms.

Source: National Audit Office based on Ministry of Defence and Annington data

How Annington has gained from the sale

2.17 The Department structured the deal to maximise the sale price. The main external risks that Annington was exposed to were significant falls in house prices or rents in the future. The contract guaranteed minimum rents and the minimum number of properties that the Department would release back for Annington for the first 25 years. These guarantees helped Annington to raise significant debt to fund the deal.

2.18 We estimate that Annington has made an annual return of around 13.4%, including inflation, for the period from the sale to March 2017.[6] At the time of the sale, the Department and its advisers estimated a return of 7.5% excluding inflation and 9.7% including inflation. The higher return achieved is primarily due to property values increasing faster than the Department had predicted in 1996 (see paragraph 2.13).

2.19 When looking at the return on equity, investors were able to achieve a higher return on their investment. In 1996, the estate was bought for £1,662 million by a consortium led by Nomura. The consortium financed the acquisition with debt and £289 million of risk capital.[7] The debt was refinanced in 1997 allowing the consortium to receive a pay back of £239 million. Since then the investors have benefited from exercising £529 million of warrants and receiving a £550 million special dividend payout as part of the sale of the estate to Terra Firma and its co-investors in 2012.[8]

2.20 Nomura sold the estate for £3,200 million, including £2,750 million of debt. The return profile on the investment implies a return on equity of 56%.[9] This return assumes that the payouts investors received during their ownership will be reinvested at the same rate. This is unrealistically high, and therefore we applied a modified return on equity in which returns are reinvested at 12.5%. On this basis, the modified return on equity for Nomura is 18.8%.

6 Valuation on the basis of fair value. The returns in this section are an estimate and may be subject to a number of factors, including the performance of the UK housing market, Annington's operational performance, and the financial structure of the investment.

7 Risk capital comprised a £75 million Note Issue credit facility; £204 million of unsecured subordinated debt (the principal of which would only be paid after the money due on the secured loans, and interest which 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.

8 A warrant is a financial instrument that gives the owner the right (but not obligation) to buy or sell a specific security at a predetermined price. The consortium members had the right to sell the warrants they owned back to Annington.

9 The return calculation is an Internal Rate of Return including inflation.

2.21 At the time they purchased Annington in 2012, the current owners (a number of investors including Terra Firma Special Opportunities Funds I and II, L.P.) injected £450 million of equity into Annington. They have not received any distributions from Annington since they bought the portfolio. Since the acquisition, the value of the portfolio has increased to £7,273 million on a fair value basis at the end of 2016-17.[10] Assuming a net debt position of £2,907 million implies a net book value of the portfolio of £4,366 million (fair value) and £5,458 million (vacant possession value).[11] After the financial year end of 2016-17, Annington refinanced all its outstanding debt and the current owners injected additional equity of £550 million. The capital injection reduces the current owners returns, but it also provides Annington with more financial flexibility going forward as it reduces the financing cost substantially and subjects it to less restrictive covenants. These new covenants make it easier for Annington to pay dividends to its investors in the future. Assuming the current owners were able to sell the entire property portfolio, they would achieve a return on their equity investment of 56%.[12]

10 The equivalent valuation on the basis of vacant possession would be £8,365 million.

11 The fair value calculation of the portfolio incorporates Annington's assumptions about the future level of rent adjustment.

12 Valuation of the return is on the basis of fair value. At the time of finalising the contents of this report, Annington's latest available set of accounts covered the year ending March 2017. Annington has refinanced all its outstanding debt in its current financial year and Terra Firma and its co-investors have injected additional equity. We have reflected the new capital injection but due to the absence of publicly available information we assumed that the net book value of its portfolio remained unchanged at its March 2017 figure.

Part Three

The value achieved from the deal in the last 21 years

3.1 In this part of the report we examine:

- the risks and responsibilities retained by the Ministry of Defence (the Department) after the sale; and
- how well the Department has managed the risks and opportunities arising from the deal.

Risks and responsibilities retained by the Department

3.2 In order to avoid prompting disproportionately poorer bids at the time of the sale, the Department retained a number of risks and responsibilities. As a result, in addition to the rent it pays on the estate it sold to Annington Property Limited (Annington), the Department continues to incur additional costs. In our 1997 report we set out information about the level of adjustment prior to 2021, although the Department did not expect that all of these factors would continue to apply beyond that point. This was because it expected guaranteed minimum rent payments to end and the estate-wide bulk discount to be lower for reasons set out in the 1997 report.[13] This adjustment reflected the fact that, amongst other things, most benchmarks of market rent for residential property assume the landlord is responsible for the management and upkeep of the property (**Figure 12** overleaf). The Department does not accept that the 1997 explanation represented a comprehensive list of the retained risks and responsibilities that justify a downward adjustment to open-market rental levels. Figure 18 lists other potential factors.

Costs of running the estate

3.3 Since 2010-11, the annual costs incurred by the Department in running the Annington estate have averaged £7,807 per property (**Figure 13** overleaf). Of this amount, 54% related to the Department's rental payments to Annington, which are shown net of the 58% adjustment on rent the Department currently receives. We estimate that management and maintenance expenditure averaged £3,602 per property.

13 Comptroller and Auditor General, Ministry of Defence, *The Sale of the Married Quarters Estate*, Session 1997-98, HC 239, National Audit Office, August 1997, Appendix 5 note 10.

Figure 12

The components of the current 58% downward adjustment the Department receives on rent it pays to Annington

This explanation was set out in our 1997 report on the sale

Description	**Adjustment (%)**
The Department's continuing maintenance obligations.	28
The bulk nature of the lettings, reflecting both the size of individual sites and the estate as a whole. The quality of the Department's covenant – that is, the assurance new owners could take that the Department, as tenant, would not default on its rent payments.	20
The benefit, to the purchaser, of the guaranteed minimum rent payments.	10
Total adjustment	**58**

Note

1 The rent the Department pays 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 reduced to reflect certain features of the Department's occupation of the estate.

Source: Comptroller and Auditor General, Ministry of Defence, *The Sale of the Married Quarters Estate*, Session 1997-98, HC 239, National Audit Office, August 1997, Box 2

Figure 13

Average annual cost to Department of the Annington estate 2010-11 to 2016-17

On average the Department has spent over £300 million per year on the estate over the period

	Average annual cost (£m)	**Average cost per property (£s)**
Total management and maintenance expenditure	142	3,602
Rental payments to Annington Property Ltd net of 58% adjustment	165	4,205
Total expenditure	**307**	**7,807**
Dilapidation costs payable to Annington upon surrender of properties	**3**	**n/a**

Notes

1 Amounts do not include income recovered from service personnel living in service family accommodation. This averaged £142 million a year during the period across the whole estate to 2015-16, including the Annington estate.

2 Figures are cash values.

3 The Department does not hold information prior to 2010-11.

4 The Department estimates the cost of managing and maintaining the Annington estate as a proportion of the cost of managing and maintaining the whole service families estate based on the number of property units.

Source: National Audit Office analysis of Ministry of Defence data

3.4 The Department has not monitored the costs of managing its sublettings to service personnel on the Annington estate, and does not know if they are reasonable. The Department does not track the wider costs it incurs managing the estate at a unit level. Neither does it attempt to map its costs against recognised benchmarks.

Maintenance and quality of the estate

3.5 In 2016 and 2017, we reported on issues relating to the maintenance of the estate.[14] Because of long-standing pressure on the Department's budget since 2009 it has carried out only essential maintenance on a 'keep me safe, keep me legal' basis, to protect the health and safety of those using the estate. Despite this, the Department's maintenance costs per unit in 2016 were 27% higher than assumed in its 1996 business case. We estimate that the Department currently spends an average of around £1,800 per property per year on core maintenance services, although it does not collect separate cost information on the Annington estate.[15] The Department's current maintenance activities do not necessarily reflect the terms of the lease, which requires properties to be in 'good and tenantable repair' at the end of the lease. The Department's consultants are currently engaged in an exercise to establish the future costs of maintaining properties to this standard.

3.6 In 2016, only around 50% of service families were satisfied with their accommodation, including the level of maintenance. The quality of service family accommodation is now measured against the Decent Homes Standard, the government's minimum standard for all those housed in the public sector. A total of 87% of properties met this standard in April 2016. This replaced internal Departmental quality standards, which ranged from standard 1 (highest) to 4 (lowest). The level of satisfaction of service families with their accommodation was the same in 2016 as in 2009 (**Figure 14** overleaf).

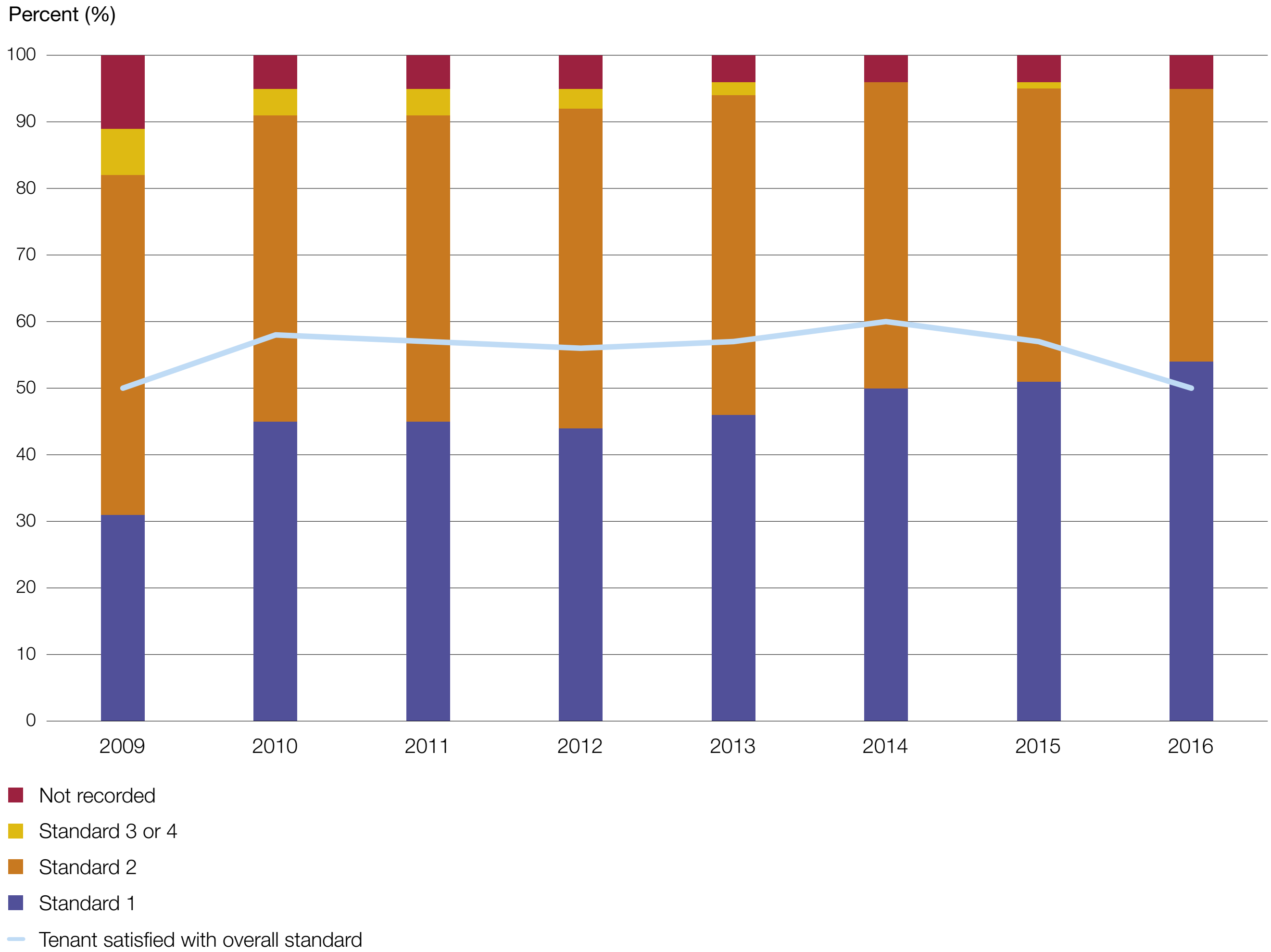
14 Comptroller and Auditor General, Ministry of Defence, *Delivering the defence estate,* Session 2016-17, HC 782, National Audit Office, November 2016; and National Audit Office, Ministry of Defence, *Memorandum: Service Family Accommodation update*, January 2017.

15 Core maintenance represents a subset of the £3,602 management and maintenance cost, shown in Figure 13.

Figure 14

Condition of service family accommodation, 2009 to 2016

An increase in the proportion of Standard 1 accommodation (the highest) has not led to an increase in satisfaction with the overall standard of accommodation



Notes

1 In April 2016, the Department assessed that 87% of its service family accommodation properties met or exceeded the Decent Homes Standard.

2 No satisfaction data are available for 2011 so the percentage used is an average of 2010 and 2012 satisfaction rates.

3 The percentage of Standard 1 accommodation increased from 31% in 2009 to 54% in 2016.

Source: Ministry of Defence

Opportunities to generate value from the deal

Treatment of surplus properties

3.7 One of the stated objectives of the sale was to improve management of the estate through greater involvement of the private sector.

Surrender of surplus properties

3.8 One of the ways that the arrangement was expected to improve management of the estate was by giving the Department an incentive to identify and surrender surplus properties. The incentive, which lasted until 2011, entitled the Department to a share of the profits that Annington made on the properties it had released. The Department released an average of 1,750 properties per year to Annington between 1996 and 2004, but the rate then slowed significantly when the Defence Estates organisation replaced the Defence Housing Executive as managers of the estate. It reduced further, following the end of the profit share agreement in 2011 (**Figure 15** overleaf).

3.9 The Department is required to return surplus properties to Annington in 'good tenantable repair and decorative order.' Since 2004, the cost to the Department of bringing properties up to this level (known as dilapidations) has been an average of £11,369 per surrendered unit. The Department has not attempted to calculate how much it would have to pay to bring the rest of the estate up to the required standard if it chose to surrender all properties. Based on an average cost of £11,369 per unit it would cost around £443 million, which might be an overestimation as the remaining properties should be maintained largely to the Decent Homes Standard (see paragraph 3.6). The Department told us that the internal quality of the estate and the scale of dilapidation payments are not always directly linked as they could be affected by factors other than the property itself.

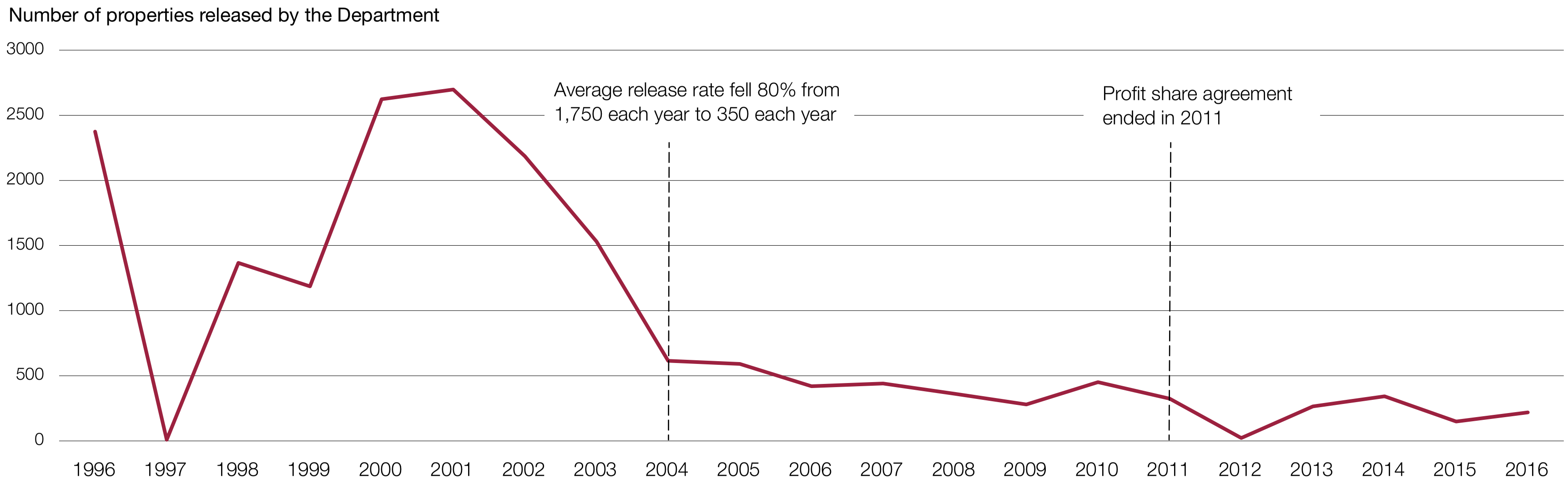
Vacancy rates and costs

3.10 The size of the overall estate has not fallen in line with recent reductions in the size of the armed forces.[16] The armed forces reduction programme announced in 2010 has led to a 22% fall in the number of service personnel. Although rental costs should have given the Department an incentive to release surplus properties as soon as possible, the current vacancy rate on the Annington estate is 19%, almost twice the Department's target.[17] We are aware of at least one site of 80 properties which has been retained in a vacant state by the Department since 1996. In April 2017, the Department was continuing to pay rent on 7,259 empty Annington properties (**Figure 16** on page 37). If these properties remained empty for the whole year, the Department would pay over £30 million in maintenance and rent on them. The Department has retained certain properties to accommodate the return of some 4,000 personnel from bases in Germany by 2019, alongside other moves. Demand will be met from a mixture of new-build accommodation and existing vacant properties. Forthcoming legislative changes will also make it easier for the Department to sublet vacant properties.

16 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.
17 The Department aims to keep 10% of its estate empty to allow some flexibility in movement of its service personnel, for example when moving between sites or returning home from overseas.

Figure 15
Number of surplus properties the Department handed back to Annington

The Department initially handed back an average of 1,750 properties a year, but the rate fell sharply from 2004, despite the continuing profit share agreement with Annington



Notes

1 The Department surrendered 13,971 properties in the first eight years and 4,475 properties in the following 13 years. As part of its arrangement with Annington, the Department agreed to release a minimum cumulative total of 13,213 properties by 2021.

2 In 1996, the Department made 2,373 properties immediately available to Annington. These properties do not form part of the agreed minimum cumulative release total.

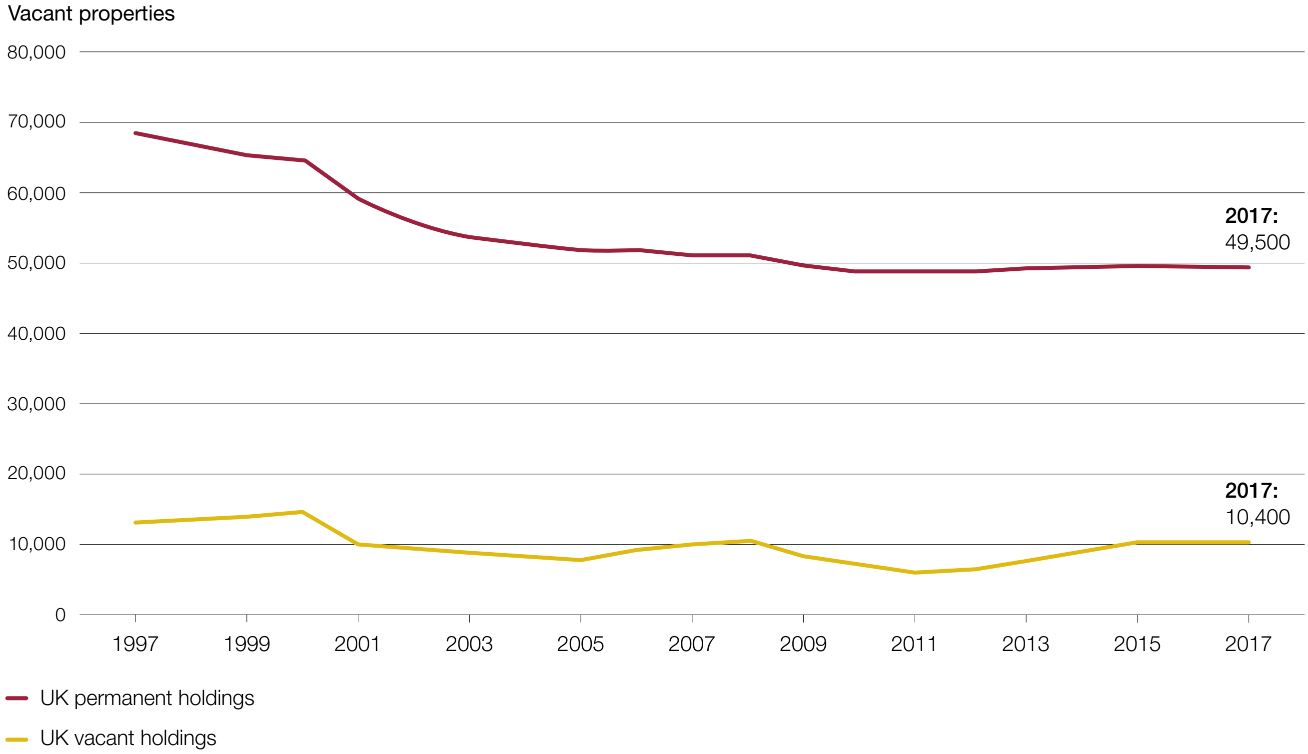
3 Under the terms of the contract, the Department can hand back to Annington any retained property it no longer requires, subject to a six-month notice period.

Source: National Audit Office analysis based on data from Ministry of Defence and Annington

Figure 16

Proportion of empty service family accommodation, 1997 to 2017

Despite a 30% fall in the number of properties, the number of vacant properties in 2017 is above 10,000 units, as it was at the time of the deal



Notes

1 Empty service family properties in England and Wales are predominantly Annington properties. In April 2017, of empty properties across the UK, 7,259 were Annington properties (19% of Annington properties).

2 In 2017, 21% of service family accommodation as a whole was empty, over twice the Department's target.

Source: Ministry of Defence

Other opportunities to generate value

3.11 An objective of the sale was to improve management of the estate through greater involvement of the private sector. At the time of the sale, the Department considered that it "could look forward to a cooperative relationship [with] the new owner…[and] in the happiest outcome a long-term partnership [with] the new owner could generate other future benefits beyond ready disposal of surpluses". In practice, there has been little collaboration in developing subsequent deals (**Figure 17**). Annington told us that its contractual relationship with the Department has been difficult to maintain over time, as there has been a succession of different departmental bodies responsible for estate issues, and regular changes in staff at senior levels in the Department. These changes have also left the Department with significant gaps in its corporate memory. The Department told us that its current relationship with Annington does not go beyond operating the terms of the contract, and also told us that it had not explored further partnership projects.

Figure 17

Examples of opportunities where additional value might have been achieved and what happened

The Department has not realised opportunities to achieve value from the deal

Background	Consideration given to working with Annington	What the Department did	What happened/how value was lost
In 1996, the Department said the deal offered the possibility of economies from accommodation maintenance and prompt surrender of surplus properties. In 2005, the Department contracted out maintenance of the estate.	Annington's ownership offered opportunities for it to maintain the estate more efficiently, given its interest in maintaining the estate well.	The Department deterred Annington from bidding for the maintenance contract. The Department considered at the time that Annington lacked the capacity and capability to provide this service. The wider group of companies, of which Annington forms part, do maintain their own properties.	Maintenance of the estate continues to face criticism. The Committee of Public Accounts reported in July 2016 that the maintenance contractor was "badly letting down service families". We cannot conclude whether using Annington would have been a better solution.
In 2007, the Department planned to increase the number of service family properties at RAF Brize Norton by building 800 new housing units to replace 600 poor quality prefabricated units.	Annington told us it could have been very competitive in bidding for the construction contract to the benefit of both parties. The Department discouraged Annington from bidding for the building contract.	The Department agreed a deal with Annington at adjoining sites. It paid Annington £21 million to repurchase land it had sold to Annington in the 1996 deal, and demolished 281 properties in preparation for the build.	The Department has not built the properties. After several years of developing plans, it has now deferred them due to lack of funds. The Department continued to pay rent on the demolished properties until buying back the site in 2014.

Source: National Audit Office work with Ministry of Defence and Annington

Part Four

The Department’s prospects for achieving value for money in the future

4.1 This part examines:

- the background to the site-based rent reviews of the estates from 2021 and the budgetary implications; and
- the Ministry of Defence’s (the Department’s) readiness to undertake the negotiations.

The current rent adjustment and the 2021 rent reviews

4.2 Until the site-by-site review in 2021, rent for each site is reviewed every five years based on a single designated ‘beacon’ (or typical) property, which is then applied to all other properties. This process will continue in the future. Until 2021, the rents include a 58% adjustment (see paragraph 2.6).

4.3 As agreed in the deal, from 2021, a multi-year review of the rent payable on all properties will start on a site-by-site basis. The process will be repeated at 15-year intervals. The negotiations, which may also result in arbitration on a site-by-site basis for each of the 511 sites, will determine the level of adjustment to be applied until the next site-based review (subject to interim reviews).

4.4 The Department and Annington Property Limited (Annington) have very different views about what will happen to rental levels from 2021. The Department set out its opening position to Annington in September 2017, stating that it expected the level of the adjustment to increase from 2021 and wanted an agreement in principle to an adjustment. The Department’s accounting officer told the Committee of Public Accounts in January 2017 that he expected to see “the [level of rent] come down very sharply”.[18] 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. In July 2017, at the time of refinancing the deal (paragraph 2.21), Annington told investors that it expected rents to rise significantly from 2021 onwards. It commissioned consultants, who calculated that there would be a continuing adjustment of 38%.

18 HC Committee of Public Accounts, *Delivering the Defence Estate*, Forty-seventh report of session 2016-17, HC 888, March 2017.

4.5 The original deal established that, in principle, there were characteristics of the deal that entitled the Department to a downward adjustment in rental payments. This agreement ends in 2021. The Department carries a number of costs and risks related to the estate which might provide the basis for future downward adjustments in rental levels after 2021 (see **Figure 18**). Many of these would normally be carried by the landlord in a residential lease. This list expands on the 1997 view of rental adjustments reproduced in Figure 12, which the Department today does not see as comprehensive.

4.6 One of these factors is the utilities arrangements between the Department and Annington. The Department currently supplies utility services, such as drinking water, electricity, and disposal of domestic sewage at base dependent sites, which are often situated in remote locations. Once the Department has handed back 75% of properties at a given site it can opt to either continue providing utilities or to stop. From 2021, the Department will not be obliged to provide these services when it releases any property from a base-dependent site. Stopping provision would result in Annington needing to make alternative arrangements for itself at significant cost, although it might also have cost implications for the Department's remaining properties on those sites.

Figure 18

Breakdown of costs and risks retained by the Department, in addition to rental payments on occupied properties

Significant risks retained by the Department include:

- Estate management, such as tenant administration (except dealing with surplus properties surrendered to Annington).
- Maintenance and refurbishment of properties, including common areas and utilities.
- Costs on surrendered properties to return them to good and tenantable repair and decorative order.
- Rentals paid quarterly in advance (terms for residential property are usually monthly in advance).
- Rent and other payments on empty properties not surrendered even if demolished.

Note

1 In addition, Annington would continue to benefit from the negligible level of risk that the Department would default on its payments.

Source: Ministry of Defence

Impact of the reviews on the Department

4.7 The Department has started preliminary negotiations with Annington. If no agreement can be reached, a process of site-by-site arbitration will be necessary. Whatever the Department's views on the likely outcome, it needs to have plans in place to deal with a range of possible scenarios.

4.8 The Department does not currently have the information it needs to make choices about what to do with each of the sites. This includes site-specific information on the asset condition of both the properties and the support utility infrastructure, an understanding of the local operational demand, the possibilities of renting properties elsewhere locally, and local development opportunities. The Department previously noted in its 1997 post-project evaluation of the original sale, that gathering comprehensive data on the estate would have taken three to five years. This meant the Department could not develop a comprehensive understanding of the in-house option before the deal. In August 2017, the Department's consultants began surveying sites to collect valuation evidence.

4.9 **Figure 19** overleaf illustrates the impact of different possible outcomes of the rent negotiations on the amount of rent paid by the Department. If the adjustment is maintained at current levels there would be no change to its annual payments of £178 million, assuming the estate remains the same size. If the adjustment ceased, the Department's annual rental payments would increase by £250 million. If the adjustment were to reduce to 38%, for example, the Department's rental payments would increase by £84 million. At this point the deal will still have up to 175 years to run.[19]

Interaction between the Annington negotiations and the Department's wider estate strategy

4.10 The Department is developing a Future Accommodation Model (FAM). This would enable more service personnel to live in private accommodation, and meet the aspirations that many have for home ownership, while improving value for money for the Department. The affordability of the FAM business case as it currently stands is dependent, among other things, on maintaining the current rent adjustment on the Annington estate.

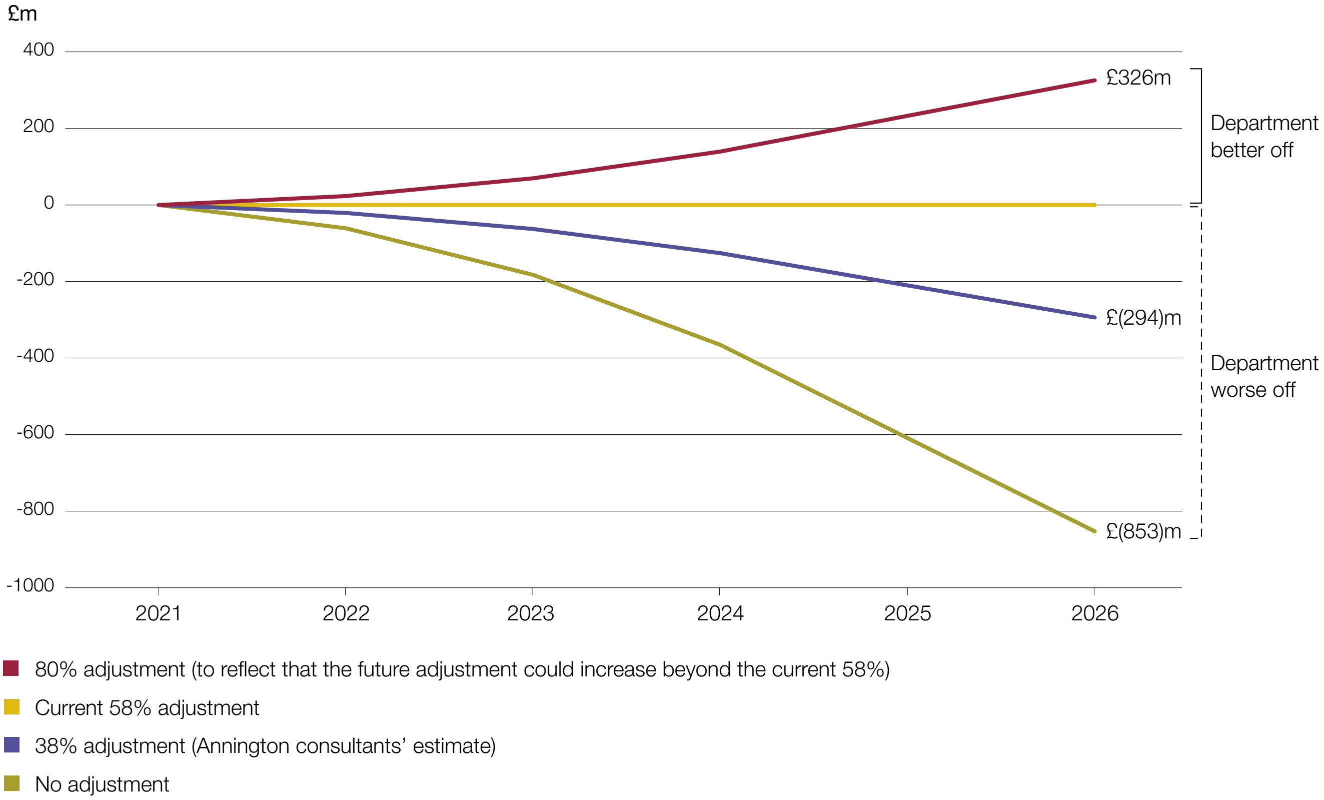
4.11 **Figure 20** on page 43 shows how strategies could affect outcomes. The Department has now signalled the start of the negotiation process (see paragraph 4.7). A pilot of the FAM's favoured approach will start in December 2018, and full implementation is due to start in 2021. If the Department's team is not provided with an understanding of future accommodation demands of the armed forces, it will make it more difficult for the team to pursue strategies for particular sites.

19 At any point the Department can surrender the estate, in whole or part, giving six months' notice and subsequently paying dilapidations.

Figure 19

The potential cumulative impact of a range of possible outcomes from negotiations on rent reviews starting in 2021

Over the five years from 2021 a notional downward adjustment of 80% to rental levels would make the Department more than £1.1 billion better off than not receiving an adjustment



Notes

1 The range of adjustments displayed is for illustration only. We do not have a view on the likelihood of any particular outcome.

2 The graph is based on current levels of rent and numbers of properties.

3 Outcomes reflect the staggered nature of reviews that we assume take place evenly over four years.

Source: National Audit Office

Figure 20

Annington outcomes, with and without strategies in place, what the Department's next steps are, and the impact of each scenario

Strategies in place ahead of outcome	Annington arbitration outcome	What to do next	Impact/Comment
Yes	Win (substantial adjustment)	Implement surrender strategy. Announce FAM decision.	Best case scenario. Provides greater certainty for service families. Optimal value for money.
Yes	Lose (insufficient adjustment)	Implement alternative strategy. Accelerate property surrenders. Announce FAM decision.	Department has a plan in place. Provides greater certainty for service families. Optimal value for money given the arbitration outcome.
No	Win (substantial adjustment)	Develop and implement a surrender strategy. Refine FAM options before making a decision.	Void properties higher than needed in short term. FAM decision delayed. Creates uncertainty for service families. Sub-optimal value for money.
No	Lose (insufficient adjustment)	Develop an alternative strategy. Accelerate property surrenders. Refine FAM options before making a decision.	Worst case scenario. Involves costly delays while developing an alternative strategy. FAM decision delayed. Creates uncertainty for service families. Poor value for money.

Notes

1 The outcome involves a range of potential adjustments agreed at each site and overall.

2 The scenarios depicted are notional situations which might, or might not, apply at the time of the negotiations.

Source: National Audit Office

4.12 In July 2016 the Cabinet Office’s Infrastructure and Projects Authority reviewed the FAM and drew attention to the crucial interdependencies between the Annington negotiations and the FAM. It emphasised the importance of coordination between the Department’s Defence Infrastructure Organisation (DIO), which leads on the Annington negotiations, and the team developing the FAM to ensure that the team negotiating with Annington is aware of alternative strategies for sites.

The Department’s approach to the negotiations

4.13 Negotiations are being led by the DIO. Senior DIO staff began preparations for the 2021 rent reviews in May 2015, including the ‘rebuild’ of existing documentation about the estate. Since 2015 the DIO has engaged property and legal consultants and set up a steering group to oversee the negotiations. The Department wrote to Annington in September 2017 to formally set out its initial negotiating position. It brought in UK Government Investments, the government’s centre of expertise in corporate finance and governance, to provide strategic and negotiation support.

4.14 The DIO is operating with a core team of ten, with supplementary input as necessary from around 30 in-house staff and consultants. In September 2017, the Department announced that it intended to terminate its contract with Capita by 2019 under which the company supplied a small number of key staff to the DIO through its lead role in the consortium acting as the DIO’s lead strategic business partner. The Department told us that this will not impact on the negotiations.

4.15 If and when the negotiations move on to site reviews, the Department should not underestimate the amount of effort required to collect and analyse information for each of the 511 sites. Some of this will come from greater input by consultants. By way of comparison, the Department for Work & Pensions (DWP) is currently re-letting its contract for the management of its office estate from March 2018. In preparation for this, it renegotiated leases for more than 900 commercial sites. It found that it initially underestimated the resource demands of this work, and the information and staff that it would need. It brought in people with expertise in managing estates transformation, and had to build up a team of more than 130 civil servants and expert secondees from consulting firms.

Appendix One

Our audit approach

1 This study examined whether the sale of most of the Ministry of Defence's (the Department's) service family accommodation offered the scope to deliver value for money effectively. We reviewed:

- the value for money of the original sale;
- the value achieved from the deal in the last 21 years; and
- the Department's prospects for achieving value for money in the future.

2 In measuring the value for money achieved, we considered what information was available at the time and how the Department used this information. Where activity could only be known with the benefit of hindsight we make this clear.

3 We applied our contractual relationships audit lifecycle framework to identify whether the Department has taken opportunities to get value for money from the deal. We modelled differences between figures in the business case and actual figures. We assessed to what extent the Department has achieved its objectives and rationales for the deal. In identifying the Department's prospects for achieving value for money in the future, we compared its approach with that of the Department for Work & Pensions when re-letting its contract for the management of its office estate.

4 To assess value for money we considered:

- Whether, besides meeting its specific short-term objectives for the sale, the Department protected its longer-term interests at the time of the deal by:
  - Constructing a robust business case.
  - Setting and meeting objectives which met its long- and short-term needs.
  - Protecting the affordability of the deal against future events.

- Whether the Department has done what it could to extract value from the deal in the last 21 years by:
  - Working with Annington to extract additional value from the estate.
  - Monitoring its own costs and acted to minimise inefficiency.
- Notwithstanding what has gone before, whether the Department is taking steps to get the best deal it can in the upcoming rent negotiations:
  - Whether it has the people and the resources in place to negotiate effectively, within its constraints.
  - Whether it has a strategy in place for its future accommodation needs and this is being used to devise a negotiating strategy with Annington.

5 Our audit approach is summarised in **Figure 21** on pages 47, 48 and 49. Our evidence base is described in Appendix Two.

Figure 21
Our audit approach

The objective of government

The Ministry of Defence (the Department) aims to provide its service personnel and their families with subsidised accommodation, reflecting a need for them to be mobile and work in remote locations. It is considered a fundamental part of the overall package for those in the armed forces, and plays a crucial role in retaining them in the services.

How this will be achieved

The Department sold the majority of its service family accommodation to Annington Property Limited (Annington) in 1996. The Department leases back from Annington the accommodation it requires. The Department set out four objectives and six associated rationales for the deal. The objectives were to:

- achieve a competitive sale;
- transfer ownership to the private sector of 80% of the married quarters estate;
- provide funds to upgrade below-standard quarters over the five to seven years following the sale; and
- improve management of the estate, providing the Department with an incentive to identify and surrender surpluses.

Our study

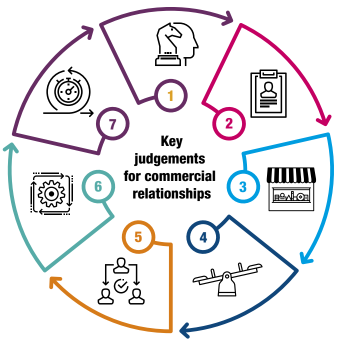
This study examined whether the sale offered the Department scope to effectively deliver value for money and to meet its objectives and rationales for the deal.

Our evaluative criteria

To assess value for money we considered:

- Whether, besides meeting the Department's specific short-term objectives for the sale, the Department protected its longer-term interests at the time of the deal.
- Whether the Department has done what it could to extract value from the deal in the last 21 years.
- Notwithstanding what has gone before, whether the Department is taking steps to get the best deal it can in the upcoming rent negotiations.

To assess the contract and commercial relationship we used the NAO's performance assessment framework.



1. Commercial strategy
2. Commercial capability
3. Market management & sourcing
4. Contract approach
5. Contract management
6. Contract lifecycle
7. Transition & termination

Our evidence

(see Appendix Two for details)

- Analysis of departmental data on the size and cost of the Annington estate and the wider service family accommodation estate.
- Analysis of departmental documents from the time of the sale.
- Analysis of Annington data, including its financial accounts.
- Interviews with departmental and Defence Infrastructure Organisation leadership, managers and staff.
- Interviews with directors of Annington.
- Mapping opportunities to achieve value for money using the audit lifecycle framework
- Back catalogue and literature review, including related NAO service family accommodation studies.

Figure 21 *continued*
Our audit approach

Conclusion on contract management

Our conclusions

Stage 1 – Is there a sound rationale for the approach being taken?

- Retaining estate in-house would have generated higher value for the Department.
- Limited modelling using assumptions that were too conservative, and sensitivity analysis too narrow.
- Over-reliant on net present value method at the expense of considering long-term cash outflows – the deal is for 200 years, unless the Department surrenders the estate.
- The objectives advanced for the sale have largely been unrealised (see Figure 5).

Stage 2 – Does the client have the required capability and is it developing capability for the future?

- The Department has not maintained sufficient internal capability.
- The Department must now develop its capability for the future.

Stage 3 – Has there been good engagement with the market to find the best partner?

- Significant interest from the market for the original deal, with 19 serious bidders.
- The Department judged Annington the clear winner on each of its four selection criteria, including highest bid.

Stage 4 – Does the balance of risk and reward provide the right incentives and behaviours?

- Decision not to transfer key risks to the private sector (notably management and maintenance risks).
- Introduced new key risk of rental payments.
- Departmental emphasis on benefit of initial cash inflow, rather than future risks.
- Deal supposedly incentivised Department to surrender surplus properties more quickly, but this is not happening.

Stage 5 – Is the contract being managed well by both client and contractor?

Failure to manage the deal throughout the contract:

- 19% of property units are empty, including some continuously empty since the time of the deal.
- Departmental intentions to generate value through close cooperation with contractor not realised.
- Department's management information insufficient and not retained over the life of the contract. No monitoring of total unit costs.
- Regular changes of key personnel and internal governance reduced corporate memory within the Department.

continued

Figure 21 *continued*
Our audit approach

Conclusion on contract management

Our conclusions

Stage 6 – Does the contract continue to demonstrate value for money?

- The Department's definition of value for money only related to initial sales proceeds.
- Since the deal, benefits anticipated at the time of the deal have not been realised.
- Future value for money is dependent on the Department securing a favourable result in site rent reviews.

Stage 7 – Is the client ready for the renegotiation of the contract?

The Department faces challenges to be ready for the 2021 site-based rent reviews, which signal a major change to the contractual arrangements as they have been applied to date:

- The Department needs to have alternative strategies for each site, depending on the possible outcomes.
- The Department is only now starting to develop a clear picture of its future accommodation needs.

Conclusions on value for money:

- The Department did not achieve value for money at the time of sale.
- The Department has not achieved value in the 21 years since the sale.
- There is a risk that the Department will fail to achieve value for money in future.

Appendix Two

Our evidence base

1 Our independent conclusions on whether the Ministry of Defence's (the Department's) arrangement with Annington Property Limited (Annington) has achieved, is achieving and will achieve value for money in the future were reached following our analysis of evidence collected between May 2017 and December 2017. We have provided more background information on our financial model and rate-of-return calculations in a technical appendix on our website alongside this report. Available at: www.nao.org.uk/report/the-ministry-of-defences-arrangement-with-annington-property-limited/.

2 In considering the value for money of the sale of the majority of service family accommodation to Annington:

- To understand why the Department sold the estate and what it aimed to achieve from the sale, we completed a **document review** of key departmental papers from the period before the sale and shortly after. These included advice given to ministers prior to the deal. We also drew on our 1997 report, in particular its judgements about the management of the sale process, about which few papers now remain.[20] The Committee of Public Accounts report on the sale also contained the results of additional sensitivity analysis that we carried out at its request.[21]

- To establish the proceeds of the sale and subsequent costs to the Department **we examined data and evaluations** on the options considered by the Department at the time of the sale. We **reworked** the Department's modelling of future cash flows included in its business case and **measured** differences between these with actual outcomes to date.

- To measure why the costs to the Department have been much higher than predicted, and whether this was foreseeable, we **analysed data** on house prices and rentals since the time of the sale. We **calculated** differences between the Department's projections of growth in the value of the estate and rental costs of the estate with actual values and costs.

- To determine how Annington has gained from the sale we **analysed** the returns made by Annington and its investors in the period since the sale and **identified** the component elements of the return.

20 Comptroller and Auditor General, Ministry of Defence, *The Sale of the Married Quarters Estate*, Session 1997-98, HC 239, National Audit Office, August 1997.

21 HC Committee of Public Accounts, Ministry of Defence: Sale of the married quarters estate, forty-eighth report of 1997-98, HC 518, June 1998

3 In considering the value achieved from the deal in the last 21 years:

To determine the risks and responsibilities retained by the Department we **analysed** departmental data on the cost of running the estate.

- To identify what additional value the Department planned to generate from the arrangement and identify whether this is being achieved we conducted semi-structured interviews with senior officials at both the Department and Annington. We also analysed data and documents on activity relating to the estate covering the period from the time of the sale.

4 In considering the Department's prospects for achieving value for money in the future:

- To understand the background to the site-based rent reviews of the estates from 2021 we carried out a **document review** which included the contractual arrangements and carried out **semi-structured interviews** with senior officials at both the Department and Annington.
- To determine the budgetary implications of the rent reviews we **assessed** how different scenarios would affect the Department's ability to achieve value for money and deliver its accommodation plans in the future.
- To determine the Department's readiness to undertake the negotiations we carried out **semi-structured interviews** with departmental officials and their advisers, and also with officials at the Department for Work & Pensions involved in re-letting a large estate contract.

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