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10 DOWNING STREET

From the Private Secretary 1 April 1982

Dear David,

International Conference Centre

The Prime Minister held a discussion this afternoon with your Secretary of State and the Chief Secretary, Treasury about the method of financing the International Conference Centre at Broad Sanctuary, Westminster.

The Chief Secretary said that he was not seeking to reopen the decision to build the Centre. But he was seriously concerned about the waste of public money in financing the Centre in the way laid down in the contract with Pearl which the Environment Secretary proposed to sign immediately. Exchequer and Audit had been examining the terms of this contract. They were highly critical of it, noting that it would involve costs much higher than those of direct public financing, but that PSA would bear all the risks associated with construction and operation. They had also pointed to the absence of a break clause in the contract over its 125 year life; and that the first rent review in 1991 assumed increasing rents in line with rents in the area not since 1986 but since 1981, so that inflation from 1981-1986 would be built into rents from 1991 onwards throughout the life of the contract. These provisions in the contract had emerged since the matter was considered by Cabinet in June last year. At that time Cabinet had been told that Pearl financing would be about 2½ times more expensive than direct public financing. It now would be 3½-4 times more expensive, and the difference would be greater still if rents were assumed to rise in real terms.

Your Secretary of State said that nothing had changed since the Cabinet took its decision, both to go ahead with the project and to accept the Pearl offer. On the basis of the Cabinet decision he had negotiated in good faith with Pearl and had negotiated a contract entirely in line with the Cabinet's authorisation. He held a letter from a reputable private sector property firm which said that the terms of the contract were as good as they could be expected to be so far as the Government was concerned. It was extraordinary that the Exchequer and Audit Department had looked into the terms of the contract even before it had been signed. He assumed that this had happened because of Treasury opposition to the whole concept. The Chief Secretary had told the Cabinet last June that Pearl finance would

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be at least 2-3 times more expensive than direct public financing. Nothing in the contract he was about to sign was inconsistent with this. There could be no question of a break clause in an arrangement of this kind, where the building was to be leased back to HMG.

The Chief Secretary said that his opposition to a contract on the lines envisaged was such that he was ready to accept that in the short term extra public expenditure should be made available for the Centre, without any requirement for the Environment Secretary to find off-setting savings elsewhere in his programme. He was prepared to agree to this in order to prevent much larger sums being spent over a longer timescale. Indeed, he was also ready to make available money to reimburse Pearl's costs in fruitlessly negotiating the contract, if the Environment Secretary were ready to accept his offer to finance the project from public funds.

The Prime Minister said that she believed that neither the Government nor the private sector would come out well from a scheme of the kind the Environment Secretary was contemplating. The certainty of a strongly critical PAC report, and the ensuing public controversy, would endanger the whole programme of bringing private sector finance into the public sector. She recognised the difficulty of changing course at this late stage, at the conclusion of the negotiations with Pearl; but she shared the Chief Secretary's view that this was a wasteful use of public funds. In view, however, of the Cabinet's earlier conclusions on the matter, she wished the issues raised by the Chief Secretary to be brought to an early Cabinet meeting. Both your Secretary of State and the Chief Secretary were accordingly asked to circulate short papers for discussion at Cabinet on Tuesday 6 April.

I am copying this letter to Terry Mathews (Chief Secretary's Office) and David Wright (Cabinet Office).

Yours sincerely,

Michael Scholar

David Edmonds, Esq.,
Department of the Environment.

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Govt. Buildings

10 DOWNING STREET

From the Private Secretary 31 March, 1982.

International Conference Centre

The Prime Minister was grateful for the Chief Secretary's minute received here last night about the financing of the International Conference Centre.

The Prime Minister has agreed that the method of financing should be reconsidered, as proposed in paragraph 7 of the Chief Secretary's minute; and I understand that signature of the contract with Pearl is in the meantime being postponed. We are accordingly arranging for an urgent discussion of the matter.

I am sending copies of this letter to David Edmonds (Department of the Environment) and David Wright (Cabinet Office).

M. C. SCHOLAR

Terry Mathews, Esq.,
HM Treasury.

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10 DOWNING STREET

Prime Minister

Agree that this should be raised at Cabinet and that Mr Heseltine (see para. 7) should postpone signing contract with Pearl?

Yes m

Duty Clerk
RR Mr Scholar 30.3.82

CHIEF SECRETARY TO THE TREASURY

PRIME MINISTER

25.6.81

You will remember that last year Cabinet decided that the International Conference Centre should be financed by a lease and leaseback arrangement with Pearl. Since then the Property Services Agency have been negotiating with Pearl, and an agreement is ready to be signed.

2. Exchequer and Audit have been examining the terms of the proposed agreement. They are highly critical of it. They point out that PAC has several times commented on the disadvantages of this way of financing Government projects. They note that in the case of the Centre it will cost much more than direct public financing, but that PSA will bear all the risks associated with construction and operation. They also point to two particular features of the proposed agreement which are potentially very expensive and are summarised briefly in the attached note.

3. The provisions mentioned by E and A have emerged since the matter was considered by Cabinet. As a result financing by the Pearl will be even more expensive, compared with direct public financing, than we thought then. I told Cabinet at the time that, assuming rents rise in line with inflation, Pearl financing would be about 2½ times more expensive than direct public financing. Now it will be 3½ - 4 times more expensive. The difference is greater still if rents are assumed to rise in real terms. Cabinet were told last year that the initial rent would be a little over 6%. But under the proposed contract the rent would rise to some 8 - 10% after 5 years.

4. I am not questioning PSA's conduct of the negotiations. It may well be that they have struck as good a deal as can be achieved with this method of financing. For their part they would accept that private financing is considerably more expensive than direct public financing.

5. I think it would be extremely damaging to the Government to proceed with this agreement. If we did, the Centre would cost the taxpayer several times more that it need. There is no way in which we could defend that. It would undermine all our efforts to get better value for money in the Government and public sector generally. We can expect the PAC to seize on these points, and perhaps make a major issue of them.

6. I am not seeking to reopen the decision to build the Centre at all. What I suggest is that it should instead be built, on the same timescale, but with public finance. I accept that in the short term extra public expenditure would have to be made available for this purpose, and I am prepared to agree to this, in order to prevent much larger sums being spent over a longer time scale.

7. I should like to suggest that we reconsider the method of financing in Cabinet in the light of the new information produced by E and A. If you agree, I assume that meanwhile Michael Heseltine will postpone signature of the contract with Pearl.

8. I am sending a copy of this minute to Michael Heseltine.

T. Mathas

for LEON BRITTAN

Approved by the Chief Secretary
and signed in his absence

ANNEX

Provision in draft agreement with Pearl to which E and A drew special attention

1. The absence of a break clause in a contract extending over 125 years. The risks are increased by another provision that rent reviews must always be upwards.

2. The rent review clause. The initial rent will be fixed in 1986, with reviews in 1991 and at five-yearly intervals thereafter. But at the first review in 1991 the rent will be increased in line with rents in the area not since 1986 but since 1981. Subsequent rent reviews will start from this higher base. Inflation from 1981 to 1986, before the Centre was completed, will therefore be built into rents from 1991 and throughout the life of the contract.

8-10%.

x 2.6

3½-4.

x 6

Ref: A08037

Govt Bldgs

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PRIME MINISTER

International Conference Centre
(C(82) 7 and 8)

BACKGROUND

In C(82) 7 the Secretary of State for the Environment seeks the Cabinet's authority to sign forthwith an agreement with the Pearl Assurance Company for the financing of the proposed International Conference Centre (ICC) on the Broad Sanctuary Site, Westminster. The Chief Secretary, Treasury recommends, in C(82) 8, that to avoid the substantial extra costs and consequent public criticism of private sector financing the project should be financed from public expenditure from the contingency reserve.

2. The Cabinet agreed on 17th July 1980 (CC(80) 29th Conclusions, Minute 4) that the ICC should go ahead only if it could be financed from the private sector. On 25th June 1981 (CC(81) 25th Conclusions, Minute 5) they authorised the Secretary of State for the Environment to accept the Pearl's offer for the financing of the project. In doing so they accepted that this would be more expensive than direct Government financing but they were unwilling to finance it from public expenditure, at the expense of other projects. They rejected the Chief Secretary's arguments that the Pearl deal did not represent genuine risk-taking private sector financing and that it was in effect a Government project financed with a mortgage from the private sector. The Chief Secretary did not, however, at that stage offer to provide additional public expenditure.

3. The present position is that the PropertyServices Agency (PSA) as project managers of the ICC have appointed Bovis as managing contractors. Bovis are poised to start work immediately. They are on a very tight schedule aimed at completion in January 1986 (in advance of the next United Kingdom Presidency of the Community in 1987) and they are now holding back pending Cabinet's decision. The PSA and the Treasury agree that if the Cabinet were to decide in favour of public financing Bovis could go ahead immediately. It follows that what is at issue is who should pay Bovis - the Government or Pearl.

4. In C(82) 8 the Chief Secretary advises that the discounted cost of financing the ICC through Pearl would be about £120 million compared with about £30 million through direct Government finance. It is known, from a draft reference sheet sent to Departments for comment, that the Exchequer and Audit Department (E and AD) are almost certain to make a highly critical report of the proposals to the Public Accounts Committee (PAC). They are critical of the absence of a break clause in a contract lasting for 125 years. The rentals are likely to be higher than previously assumed because the first rent review in 1991 will permit rents to be increased in line with rents in the Victoria area since the design date of 1981, rather than since the completion date of 1986. The Chief Secretary feels so strongly over the deal that he is prepared to make the necessary additional public expenditure available and, in principle, to agree to some reimbursement of the abortive expenditure incurred by Pearl and the Government's advisers.

5. In C(82) 7 the Secretary of State for the Environment argues that he has negotiated, to the point of signature with the Pearl, a deal as authorised by the Cabinet and that it can be defended as the best that can be obtained from the private sector. He contests, in paragraph 8 of his paper, that the deal is not necessarily three-and-a-half to four times as expensive as public financing; though he recognises, as he always has done, that it is substantially more expensive. He is clearly concerned over the prospect of a row with the Pearl over the Government's good faith and intentions for this project and, more generally, he sees this as damaging the Government's credibility in encouraging the private sector to participate in joint financing of other public sector projects.

6. Although it is not mentioned in either of the two papers before Cabinet, you will recall that on 11th March (E(82) 8th Meeting, Item 1) the Economic Strategy Committee agreed that the Secretary of State for the Environment could seek to develop the approach to private investment in the construction industry set out in his paper E(82) 22, on the understanding that particular projects would each be examined in consultation with the Chief Secretary against the criteria in Annex B to that paper. Those criteria were specifically designed to ensure that,

to offset the higher financing costs of private finance for public projects, it could be demonstrated that the private sector were taking on substantive risks and that their participation would lead to the more efficient execution of the project and to savings in either capital or operating costs. It seems implausible that the Pearl proposals for financing the ICC would meet these criteria.

MAIN ISSUES

7. It is common ground that the project should go ahead and that the aim should be to complete it in early 1986. It is beside the point, raised by the Chief Secretary, that the Pearl deal is probably the best private sector deal which could be constructed for financing the ICC. The question before the Cabinet is whether the project should be financed by public expenditure, found from the contingency reserve, or at considerably more expense through the Pearl arrangements.

8. It has to be accepted that the Government is liable to criticism either way. The Pearl could reasonably complain that the Secretary of State for the Environment was backing out, at the very last moment, from a deal in which he had strongly encouraged them to participate. The Secretary of State for the Environment, and other Members of the Cabinet, may well say that it is a pity that the Chief Secretary, and his predecessor, did not concede in either 1980 or 1981 that the project should be financed from public expenditure.

9. On the other hand there is no escaping that if the deal goes ahead there will be an adverse report from the E and AD and that the project is likely to be severely criticised by the PAC. There is no doubt that private sector financing would be very substantially more than public sector financing (and I doubt whether there is any point in the Cabinet getting into detailed arguments as to whether it is two, three or four times as expensive) and it would be very difficult to mount a convincing counter-argument to refute the PAC's criticism. If this assessment is right, the Pearl's participation in the financing of the ICC would represent a poor start to any general initiative by the Government to encourage private sector financing of public sector projects. As noted above, it is most unlikely that the Pearl deal would meet the criteria very recently approved by E Committee.

HANDLING

10. To avoid the discussion ranging unnecessarily widely, you might point out to the Cabinet at the outset that there is no question of going back on the decision to build the ICC and that the question before them is the limited one of how it should be financed. It is important that the Centre should be built to the timetable proposed and it would be a waste of time to look now for alternative financing solutions. The choice is the Pearl deal or public expenditure.

11. You will then wish to invite the Secretary of State for the Environment and the Chief Secretary to speak to their papers. Since the question is wholly about financing no other Minister has a clear departmental interest though you might, perhaps, call on the Secretary of State for Industry to comment.

CONCLUSIONS

12. In the light of the discussion you will wish to record a conclusion on whether the International Conference Centre should be financed on the basis of the proposed agreement with the Pearl Assurance Company, as recommended by the Secretary of State for the Environment in C(82) 7, or by public expenditure as recommended by the Chief Secretary, Treasury in C(82) 8.

RA

Robert Armstrong

5th April 1982

ACTION

2 Prime Minister
AMS 2/iv

Mr Whitmore

C(82) 8 COPY NO 2

2 April 1982

CABINET

THE INTERNATIONAL CONFERENCE CENTRE

Memorandum by the Chief Secretary, Treasury

1. Last year Cabinet considered the financing of the International Conference Centre. It decided, given that extra public expenditure was not available, that the Centre should be financed by a leasing arrangement with Pearl Assurance.

2. Since then circumstances have changed. Exchequer and Audit have examined the proposed contract with Pearl. They are highly critical of it. They point out that the Public Accounts Committee (PAC) have several times said they are opposed to this way of financing Government projects. They note that in the case of the Centre it would cost much more than direct public financing, but that the Government would bear all the risks associated with construction and operation. They point also to two particular features of the proposed agreement which are potentially very expensive. The first is the absence of a break clause, in a contract lasting for 125 years. The absence of a break clause is all the more risky in view of another provision in the proposed contract, that rent reviews must always be upwards. The second is the rent review provision itself. It now emerges that, for a reason summarised in the Annex, this would work in a way which substantially increases the cost of the contract, above what we expected last year.

3. Cabinet did not know when it considered the matter that there would be no break clause and that the rent review provision would take the very expensive form it has. The arrangement is now a much worse deal for the Government than we believed at the time. I now calculate that it would cost four times as much to finance the Centre in this way as by direct Government financing, as compared with the two to three times I estimated last year. The discounted cost of financing the Centre through Pearl would be some £120 million as compared with only about some £30 million through direct Government finance. The return to Pearl would also be much higher than the figure of just over 6 per cent we believed at the time. Although it will start at 6 per cent, it will rise to 8-10 per cent after only five years and stay at that level for the remainder of the 125-year contract.

4. I am sure that it would be wrong and damaging to proceed with this contract. We would be accused of saddling the taxpayer with an arrangement costing him several times more than it need. It would undermine all our efforts to get better efficiency and value for money in the Government and public sector generally. The Exchequer and Audit enquiries show that PAC will pick up these points. They could indeed make the matter a major embarrassment to us.

5. I am not seeking to reopen the decision to build the Centre. I accept that it should be built, in the timescale now planned. I propose that it should instead be built with public finance, and I am prepared to make the extra sums available accordingly. These would be £6 million in 1982-83, £13 million in 1983-84, £16 million in 1984-85 and £5 million in 1985-86. I would also be ready in principle to agree to some reimbursement of the abortive expenditure incurred by Pearl and the Government's advisers. The sums would be minute compared with the savings from giving up the contract.

6. The arrangement I propose would therefore enable us to build the Centre exactly as planned but it would avoid substantial unnecessary costs and highly damaging criticism of our failure to protect the taxpayer's interests.

L B

Treasury Chambers

2 April 1982

ANNEX

RENT REVIEW CLAUSE IN DRAFT AGREEMENT WITH PEARL

The initial rent will be fixed in 1986, when the Centre is due to be complete. There will be reviews in 1991 and at five-yearly intervals thereafter. But at the first review in 1991 the rent will be increased in line with rents in the area not since 1986 but since 1981. Subsequent rent reviews will start from this higher base. Inflation from 1981 to 1986, before the Centre was completed, will therefore be built into rents from 1991 and throughout the life of the contract.