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Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Lord Young of Graffham
 Secretary of State for Trade and Industry
 Department of Trade and Industry
 1 - 19 Victoria Street
 London
 SW1H 0ET

17 February 1988

Dear Secretary of State,

ENGLISH ESTATES: MANAGED WORKSPACE IN THE INNER CITIES

will REQUEST IF REQUIRED

Thank you for your letter of 8 February. I fully take the importance you attach to the introduction of a managed workspace scheme with substantial private sector involvement as part of our approach to the problems of the inner cities. But I still have considerable reservations over the particular mechanisms you have proposed for engaging the private sector in the property development aspect of this. As they stand these seem likely to offer poor value for money.

As you are aware, in order to test the value of property development grants (PDG) I have recently agreed to the introduction of a small scale experimental scheme involving its use for advanced factory building in Wales, where target grant levels are significantly lower than those you have proposed, the task of finding a tenant (and associated risk) rest with the private developer, and the arguments in favour of a demonstration effect more powerful. I do not believe a further scheme using PDG with higher levels of subsidy would be sensible ahead of evaluation of the results of that experiment.

Even on the calculations supplied by your officials, which I believe may be optimistic, PDG at the proposed level of up to 50 per cent of capital costs would both be substantially less cost effective than direct provision by English Estates, and would still be insufficient to bring about development on the illustrative assumptions used. Further, in my view it is unlikely that the kinds of developers who might be interested in building such workspace on the basis of PDG will wish to have a long term involvement with the property once built. They will typically be looking simply for short term profits based on the public sector subsidy. I am unconvinced that this would represent the sort of constructive engagement of the private sector for which we are looking or have any useful demonstration effect.

The second mechanism proposed, involving the use of rental guarantees to private investors for up to 25 years, would be unprecedented and would represent a significant and unwelcome extension of contingent liabilities which could involve us incurring expenditure for many years after the scheme which gave rise to them has ended. Both for this reason, and because the scheme involves the public and private sectors investing in the same projects on such manifestly unequal terms, its justification is likely to be scrutinised particularly closely, including by the Public Accounts Committee. Even on the calculations supplied by your officials the use of private sector investments supported by such guarantees would be less economic than direct provision by English Estates. Any justification on wider cost effectiveness grounds would therefore be forced to rely on judgements about the value of pump priming and the demonstration effect without much evidence that could be directly related to the mechanism in question. I would see particular difficulty in defending the Government guaranteeing for 25 years initial yields higher than those at which it would itself borrow money - i.e. those available on long term gilts.

I am also concerned about wider repercussions for our ability to resist proposals involving sale and leaseback which do not offer value for money. I could not agree to English Estates offering such an arrangement. Even assuming this is avoided, given the proposed role of English Estates as initiator, investor and property manager there is a risk that your proposal will be perceived as equivalent to sale and leaseback and raise unrealistic expectations which will subsequently have to be dashed.

For all these reasons I have serious reservations about your proposals.

However, given the importance of an early announcement to coincide with publication of the Government document on the inner cities, I accept that we cannot easily draw back at this stage. But I am sure that we must proceed with considerable care; and I could agree only to the use of long term rental guarantees as part of a carefully targetted and tightly controlled experiment. I would therefore want to add the following conditions to the controls already incorporated within your proposal:

- (i) The total expenditure commitments incurred over the 3 years of the initial experiment plus total net present value of all rental guarantees given not to exceed £40 million.
- (ii) The guaranteed initial yield to the private sector investor not to exceed the average return available on long term gilt edged stock at the time the guarantee is given.

We would also need to agree on guidelines for the selection of projects, letting policy and monitoring and evaluation of the experiment. The arrangements for the management of the workshops once built, on which your proposals are sketchy at

present, will be central to the success of this scheme. I believe that we should be looking in each case for private sector management willing to commit themselves to the project for not less than 5 years, who can demonstrate likely commercial viability in the longer term and cover for any expected short term revenue shortfalls without subsidy by English Estates. We will also need to agree on the way in which the scheme will be presented publicly and to potential private sector investors, so as to minimise the risk of undermining our position on sale and lease back.

Finally we need to consider the treatment of expenditure on this scheme for the purposes of expenditure control. To the extent that we are successful in attracting private sector finance this will reduce the capital costs to English Estates, and I would normally need to insist that total expenditure counts against your Survey provision with an appropriate adjustment for any private sector finance attracted by public sector guarantees. However, in the present case I can see the difficulty that might cause you and if we were able to agree on the terms of a carefully limited experiment along the lines I have outlined then I would be prepared to consider further its treatment for control purposes.

If we are to be in a position to make a further announcement on the managed workspace programme to coincide with the publication of the document on inner cities we need to reach agreement quickly. I would be happy to meet for a discussion if you feel that would help to take matters forward.

I am copying this letter to the Prime Minister in view of the relevance of this issue to the forthcoming publication on Inner Cities.

Yours sincerely,

Jim Rafter

PP JOHN MAJOR

(Approved by the Chief Secretary,
signed in his absence).