INFORMATION NOTE

Public Private Partnership Cases involving Land Development in the United Kingdom and the United States

1. Introduction

1.1 In October 1998, the Chief Executive announced in his Policy Address that the Government was planning for a new, state-of-the-art performance venue, the West Kowloon Cultural District (WKCD), on the West Kowloon Reclamation. In April 2001, the Government launched an open Concept Competition to invite conceptual plans for the development of WKCD, which resulted in a total of 161 entries from local and overseas participants. While the first prize was awarded to Foster and Partners, the Government stated that there was no linkage between the competition and the eventual development right of the project.

1.2 In September 2003, the Government launched an Invitation For Proposals. The successful proponent would be required to plan, design, finance, construct, procure, fit out and complete WKCD and subsequently operate, maintain and manage the core art and cultural facilities for a period of 30 years. A land grant of the site for a term of 50 years in favour of the successful proponent will be executed at such time as the Government considers appropriate after the execution of the project agreement. Five submissions were received when the Invitation For Proposals closed on 19 June 2004. The result of the screening was announced on 10 November 2004. Three consortiums, namely World City Culture Park Limited, Sunny Development Limited and Dynamic Star International Limited, were screened-in for further assessment.

1.3 There have been concerns raised by the development industry and relevant professionals regarding whether the development right of WKCD should be granted to a single developer, and Members of the Legislative Council have also queried whether the piece of land should be granted to the successful proponent for a term of 50 years. The ensuing sections summarize the development of two public private partnership projects involving land development in the United Kingdom (UK) and the United States (US) respectively to facilitate Members' deliberation.

2. The Royal Armouries Museum in Leeds

Background

2.1 The Royal Armouries Museum in Leeds was one of the very first Private Finance Initiative projects carried out in the UK. In December 1993, the Royal Armouries[1] (the Armouries) signed a contract with a private sector company, Royal Armouries International plc[2] (RAI), for the latter to build and operate a new museum in Leeds for 60 years. The contract also involved the redevelopment of the surrounding Clarence Dock[3] site by both the Armouries and RAI.

Objectives

2.2 The objectives of the Royal Armouries Museum project were as follows:

(a) to provide a mechanism for the private sector to make financial contributions to public works projects and to allow for the sharing of returns between the public and private sectors;
(b) to achieve the maximum risk transfer to the private sector;
(c) to obtain maximum private sector funding;
(d) to allow the private sector to control both the construction and operation of the new museum;
(e) to enable the Armouries to maintain control over the curatorial and heritage components of the project;
(f) to meet the statutory duties of the Armouries[4]; and
(g) to reduce the need for grant-in-aid from the sponsoring department[5] by using the profits generated from visits by the public.

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1 The Armouries is the oldest national museum in the UK, which was started as the main royal and national arsenal housed in the Tower of London. It occupies buildings within the Tower for making and storing arms, armour and military equipment.

2 RAI is a consortium composed of 3i, Gardner Merchant, Electra and Yorkshire Electricity.

3 Clarence Dock is a mixed-use property development at the waterfront of Leeds. This area has been transformed into one of the premier destinations in the UK providing a stylish working environment, first-class leisure entertainment facilities as well as luxury apartments and retail outlets.

4 According to the National Heritage Act 1983, the Armouries must (a) care for, preserve and add to the objects in its collections; (b) secure that the objects are exhibited to the public; (c) secure that the objects are available for study and research; (d) maintain a record relating to its collections, to arms and armour in general and to the Tower of London; and (e) generally promote the public's enjoyment and understanding of arms and armour.

5 Before 1992, the sponsoring department of the Armouries had been the Department of Environment. Thereafter, a newly established department, the Department of National Heritage, took over responsibility. In 1997, this department was renamed the Department for Culture, Media and Sport. The Museums & Libraries Sponsorship Unit within the Department for Culture, Media and Sport provides advice to the government, museums and galleries on a wide range of policy issues. It also provides support and sponsorship to 22 museums and galleries.

Selection of the Public Private Partnership partner

2.3 Although the Armouries tried to market the project to the private sector, only two potential bidders expressed interest in this project. One potential bidder withdrew after undertaking some feasibility studies. As such, only one proposal was received and RAI was selected as the public private partnership partner. A joint venture was then established between the Armouries and RAI.

The 1993 Agreement

2.4 According to the 1993 Agreement between the Armouries and RAI, the former was responsible for maintaining and preserving its collection, while the latter was responsible for the development of the project and operation of the properties. The Armouries also provided curatorial staff for the museum and paid the lease rental to the owner of the site[6], the British Waterways.[7] While RAI would retain all income the museum generated from visits by the public, the Armouries would share the profit made by RAI in the event that the number of visitors exceeded 1.3 million.

2.5 RAI was responsible for building the museum in accordance with the design provided by the Armouries as well as operating it for 60 years. While RAI received no management fee, it would retain all income the museum generated from admissions, retailing, catering and car parking services. RAI would pay for the operating expenses, except those marketing and promotion expenses which were financed by the Armouries. RAI would also reimburse the Armouries for the rent payable annually to the British Waterways.

2.6 The 1993 Agreement stipulated that the joint venture was responsible for approving the development scheme of the leased area. The two partners would also share the profit arising from the development of the surrounding Clarence Dock site.[8]

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6 The Armouries obtained a 999-year head-lease from the British Waterways for the museum site and its immediate surrounding area. In turn, RAI obtained a 60-year sub-lease from the Armouries.

7 The British Waterways is a public corporation managing more than 3 220 km of canals and rivers in England, Scotland and Wales. The corporation uses its income to conserve and enhance the waterways.

8 Under the development agreement among the Armouries, RAI and the Board of the British Waterways, the owners of the site's freehold, both the Armouries and RAI, were to share in any profit arising from the development of the area the Armouries leased. RAI, in addition, was entitled to further development gains arising from the area not leased by the Armouries.

Financial arrangements

2.7 The cost of building the new museum was about £42.5 million. While the Armouries, the Leeds City Council and the Leeds Development Corporation contributed £20 million, £3.5 million and £5 million respectively, RAI contributed the remaining £14 million.[9]

Problems

Low visitor numbers led to financial losses

2.8 Although the museum was delivered on time and within budget, and it also won a number of national and international awards, visitor numbers and thus revenue generated were much less than estimated. In 1999, the losses incurred were estimated at £10 million. One reason attributed to the low visitor numbers was the high admission charges to the museum.

Lack of passing trade owing to the delay in the development of Clarence Dock

2.9 The shortfall of visitors could also be attributed to the lack of passing trade resulting from the delay in the development of Clarence Dock. The concerned parties – the British Waterways, the Armouries and RAI – had not selected a developer for the site until July 1997, when the Berkeley Group, a private developer, paid £13.4 million for a lease-hold for the undeveloped area of the site for 150 years. Nonetheless, the aforementioned three parties could not agree on the share of the proceeds obtained from the Berkeley Group.

2.10 Other reasons for the delay in the development of the site included the negotiation between the Armouries and the Berkeley Group regarding additional space for exhibition and storage as required by the Armouries,[10] and the lengthy process required for obtaining the approval of planning for the development. As a result, construction for the first phase of residential apartments could not begin until 2002. The whole project is scheduled to be completed by 2006.

9 National Audit Office. (2001). *The Re-negotiation of the PFI-type deal for the Royal Armouries Museum in Leeds*. London, The Stationery Office.

10 The Armouries required the Berkeley Group to construct an extension of 40 000 sq ft of space for displaying and storing its collection. The cost of this additional space was estimated at £2.8 million and was in lieu of the Armouries' share of development gain. The Armouries also sought the provision of another 30 000 sq ft of space for future expansion.

Unclear contract provisions for termination of contract

2.11 Owing to the lack of experience in the operation of the new museum, the Armouries and RAI decided to delay the discussion on the specification requirements and standards of performance in operational areas, such as income generation and maintenance of the museum, until the opening of the museum. However, the agreement could not be finalized because of the financial difficulties RAI encountered and the unpredictability of visitor numbers. Therefore, there were no benchmarks available for monitoring the performance of RAI. Meanwhile, the Armouries was unable to terminate the contract even though it was not satisfied with the performance of RAI.

2.12 Even if RAI went into receivership, the Armouries could not terminate the contract immediately and take possession of the museum because there was a two-year moratorium on the right of the Armouries in taking over the museum in the event that RAI became insolvent.

2.13 The Armouries also had difficulties in getting timely information on the true financial situation of RAI as, under the agreement, it could not access RAI's financial records.

<u>Outcome</u>

2.14 The Armouries and its sponsoring department considered a number of options for dealing with the financial crisis. The three viable solutions for the Armouries were as follows:

(a) to finance RAI's losses by securing more grant-in-aid from the sponsoring department;

(b) to close the museum after RAI went into receivership; and

(c) to take over the operation of the museum, with RAI being remained as a shell company.

2.15 While option (a) was considered the most expensive option, option (b) was the cheapest choice. However, if the Armouries chose option (b), it would be considered as failing to comply with its statutory duties. In addition, the Armouries might need extra grant-in-aid to either pay for new accommodation to display its collection or pay off RAI's creditors in order to gain immediate access to the museum. Meanwhile, the political impact of the closure of a national museum could also be considerable.

2.16 With a view to minimizing the impact, RAI proposed option (c) in which the Armouries would take over the operation of the museum, while RAI would provide other services to the public at the museum. In July 1999, the Armouries and RAI reached another agreement restructuring their relationship with regard to the project as well as providing a framework for completing the Clarence Dock development.

2.17 Under the revised agreement, the Armouries would operate the museum and meet its operating costs from the income the museum generated. The Armouries would also receive from its sponsoring department an extra grant-in-aid of £1 million a year. The Armouries would also transfer its share of the future proceeds from the Clarence Dock development to RAI for paying back RAI's debt.

2.18 Under the revised agreement, RAI retained the responsibility for the provision of corporate entertainment and catering for 40 years, and car parking for 57 years. However, the revised agreement did not contain details of the level of charges RAI would levy on visitors for these services, although the imposition of these charges required the approval of the Armouries on an annual basis. RAI would also operate, and retain the income from, a new exhibition hall, being constructed as part of the Clarence Dock redevelopment, for 57 years or until its bank debt being fully repaid, whichever was the earlier. Once RAI paid off its debt, it had to pay 20% of its income to the Armouries.

2.19 The revised agreement also stipulated the standard of performance to be met by RAI for its catering, car parking and corporate hospitality services. In the event that RAI breached the revised agreement, the Armouries could terminate its provision of these services.

3. The Regional Office Building of the Department of Veterans Affairs in Houston

Background

3.1 In 1992, the 20-year lease on the regional office building of the Department of Veterans Affairs (VA) in Houston[11] with the General Services Administration in the US was about to expire. Since the building was in serious disrepair, VA chose to relocate its regional office to the grounds of the Veterans Affairs Medical Centre (VAMC) campus which had approximately 20 acres of available land. In this connection, VA could reduce costs and enhance its services to veterans by placing the office near other campus services.

3.2 In 1991, Congress enacted legislation authorizing the Secretary of Veterans Affairs to enter into long-term agreements called enhanced-use leases (EULs)[12] with the private sector, and the regional office project was the first public private partnership project accomplished under the EUL programme. With a view to financing the development of facilities and the provision of services as well as to redeveloping the 20-acre land, VA entered into a 35-year development partnership with a local developer. In 1992, Congress provided VA with US$17 million to construct the new regional office building on the VAMC campus.

Selection of the Public Private Partnership partner

3.3 In September 1991, a public hearing and the accompanying congressional notification, as required by the EUL legislation, were conducted. VA sponsored a national competition for the development of the office building and some VA-approved commercial developments on the VAMC campus site. Eight developers submitted proposals. In January 1993, VA selected Amelang Partners, Inc (API), a private real estate developer, to design, build, and maintain the office building of VA as well as to develop the 20-acre site.

11 The regional office of VA in Houston administers a variety of services and benefits for approximately 876 000 discharged/retired veterans of the US Military and their dependents residing in the southern part of Texas, the Republic of Mexico, and Central and South America. These benefits include Compensation and Pension programs, Home Loan Guaranty, Vocational Rehabilitation and Counseling, and Death Benefits.

12 EUL is an asset management programme in VA comprising a variety of leasing arrangements (e.g., lease/develop/operate, build/develop/operate). EUL enables VA to lease their properties to the private sector for non-VA uses in return for cash or in-kind consideration. VA can keep all or part of such cash or in-kind goods or services received to finance or support other operations. Prior to the introduction of EUL, any proceeds received from leasing out under-utilized assets had to be submitted to the Department of Treasury.

Provisions of the Enhanced-Use Lease

3.4 Under the 35-year EUL, API would design, build, and maintain the regional office building and the 500 parking spaces, and VA would lease-purchase the building within a one-year period after its construction at savings of more than 30% of the amount appropriated by Congress. API would also provide operation and maintenance services to VA at reduced costs.

3.5 In addition, API would develop and maintain the remainder of the 20-acre site. It would build 29 000 sq ft of VA-approved commercial properties including medically-oriented offices[13], a hotel and some retail outlets. API would pay a percentage of the rental received from these properties, estimated at over US$2 million, to VA. VA would use this money to help fund costs of its medical care and nursing home programmes. At the end of the 35-year lease, VA would take over the ownership of these commercial properties.

Outcome

3.6 Owing to API's experience and familiarity with federal contracts and sufficient funding obtained by VA from Congress, the regional office building and the parking facility were completed within 11 months. The project also earned a Hammer Award[14] from Vice President Gore's National Performance Review for its contributions to VA's efforts to improve business practices and provide better services to veterans. As of September 1998, all of the commercial developments were completed and open.

3.7 The EUL approach reduced the time for the structuring and implementation of this project, resulting in significant cost savings over VA's own design and development. VA purchased the office building from API for approximately US$11 million, which was US$6 million less than the appropriation made by Congress. VA also saved an additional US$10 million in operation and maintenance costs over the 35-year term contract. Currently, API pays VA about US$75,000 annually from revenues of the commercial properties. This amount is in addition to a one-time US$75,000 rental payment made by API at the execution of the lease.

[13] These medically-oriented offices included a dialysis centre, a dental office and a biomedical research and development centre.

[14] The Hammer Award is given to a person or team whose efforts dramatically improve the way the government does business.

Factors attributed to the success of the project

3.8 EUL allowed VA to eliminate and streamline many processes required in government acquisitions. For example, VA did not need to adhere to the federal contracting procedures. Nonetheless, by policy, the business plans of the EUL projects of VA had to be approved by the Secretary of Veterans Affairs, which served as a safeguard.

3.9 As the EUL legislation required public hearings to be held on proposed partnerships to determine their possible impact on veteran services, employees, local businesses and the community, VA advertised their public hearings in local newspapers, and gave written notices to individuals or groups who had an interest in the project.

3.10 VA also established the Office of Asset and Enterprise Development within their Facilities Management Office to promote the partnership concept within VA and to develop policies and procedures for carrying out the day-to-day tasks of designing and implementing partnership projects. This office provided a single point of contact for the partnership and was staffed with professionals experienced in portfolio management, architecture, civil engineering, and contracting.

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