

## **Administration of the Crown Estate in Scotland – A Case for Change**

*“There is no organisation in the world quite like The Crown Estate.”*

Website of the Crown Estate Commissioners

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The Crown Estate has recently moved to the forefront of the political debate in Scotland, with Alex Salmond, the First Minister, making reform of the Crown Estate one of six demands for revision of the Scotland Bill. Currently, its management is carried out by the Crown Estate Commissioners (CEC). In this article we report on fresh research we have undertaken concerning the CEC’s partnership in a major property deal in Edinburgh: this research raises a number of further questions regarding the activities of the CEC, and their future potential adverse impact on economic development in Scotland.

We begin by looking at some general background on the Crown Estate, and we briefly summarise some of the issues raised by researchers, in particular the considerable work carried out by Andy Wightman.

As the Scottish government put it “The Crown Estate is the collection of property, rights and interests belonging to the Crown - and, ultimately to the people - that are managed by the Crown Estate Commissioners.”[1] Or, as a working group of Highland Authorities put it more pithily when they reviewed the Crown Estate, “The Crown Estate is a form of public land managed by a public body for public benefit“.[2]

In Scotland, the property that makes up the Crown Estate includes the rights to the seabed within Scotland's territorial seas out to the 12 nautical mile limit, and rights over the continental shelf up to the 200 nautical mile limit (excluding hydrocarbons). It also includes a number of large rural estates and urban properties. But it is the marine elements of the Scottish Crown Estate which are potentially hugely valuable as wind and alternative energy sources are developed.

The role of the CEC was set out in the Crown Estate Act of 1961. The act defined their duty as being “to maintain and enhance its value and the return obtained from it, but with due regard to the requirements of good management.” This form of words actually gives the CEC considerable latitude: it is by no means clear whether their primary function is to manage the estate as good socially conscious landlords, or to be profit maximisers. And it was this confusion which became one of the main subject areas of discussion in the review of the management of the Crown Estate carried out by the House of Commons Treasury Committee in 2009–10. [3] For example, with regard to the management of the marine estate, the Committee reported “In the marine environment, stakeholders are concerned by the emphasis the CEC are placing on revenue rather than long-term development and by CEC’s monopoly position.” and “We consider that the CEC ought to be able to adopt an approach that is more sympathetic to facilitating the development of local socio-economic benefit.”

Two other aspects of the 1961 Act are important. First, the Act specifically precludes the CEC from borrowing. The Act does not indicate why this was thought necessary, but restricting the CEC in this way makes sense, for a number of very good reasons. In particular, it avoids the danger of the CEC becoming highly debt geared property speculators, with the attendant risk of incurring large losses. Second, the Act specifies that the CEC should comply with directions from either the Chancellor of the Exchequer or the Secretary of State for Scotland. In practice, it appears that the Secretaries of State for Scotland have never availed themselves of this power. As we shall see, however, this is potentially a very important issue.

The management of the Crown Estate in Scotland and its revenues are both reserved under the Scotland Act 1998 with the revenues going directly to the Treasury. The Scottish Law Commission gave guidance as follows: “The constitutional aspects of the Crown and the management of the Crown Estate are reserved matters. However, the Crown's prerogative functions are not reserved nor is property belonging to the Crown. The Crown's interest as proprietor of the foreshore and sea bed and the public rights held by the Crown in trust for the public are therefore not reserved”. Matters concerning ownership and regulation are therefore devolved. However, in 2002, despite the Crown property, rights and interests in Scotland that are managed by the CEC being legally different from those forming part of the Crown Estate in the rest of the UK, the CEC ceased to treat Scotland as a separate business division. Thus, the CEC has become less rather than more devolved: for example, the urban estate is considered by the CEC for the UK as a whole, is handled by the London office, and there are no separate detailed accounts available for Scotland. As a result, although ownership is devolved, there have been cases where Scottish Crown Estate assets have been sold and the receipts used to purchase assets in England: although this means that the Scottish estate was diminished, there was no involvement from the Scottish Parliament.

In fact, under its present leadership, the CEC has not made it clear in its literature and in its statements that its role is fairly clearly defined as being in management, not ownership. Not only do the CEC market themselves as being the Crown Estate, but, in his appearance before the Scotland Bill Committee of the Scottish Parliament, Roger Bright, the chief executive of CEC said, “Perhaps it is worth bearing in mind that there is a clear distinction between ownership of the sea bed and the regulation of it, which clearly lies with the Scottish Government and Marine Scotland. We do not have a regulatory role; we are just the landowner. In that capacity, we seek to work closely with the Scottish Government so that we can understand its policy objectives and try to work out how we can best work with them.” In fact, the CEC are not the landowner: they manage the estate for the landowner – which is the public in Scotland.

Andy Wightman, an independent writer and researcher on issues of land, and author of *Who Owns Scotland*, has been one of the most diligent writers on the operation of the Crown Estate Commissioners with regard to the Scottish Crown Estate. He has pointed to the opaqueness of the CEC's accounts: and to their being little detail in their Scottish accounts. More recently he has analysed George Osborne's Sovereign Grant Bill which provides for a new method of financing the Monarchy linked to the revenue of the Crown Estate. As Andy Wightman says, “Importantly, however, this is

merely a formulaic link. The Crown Estate revenues will still be paid directly to the Treasury and there will be no hypothecation to the Royal Household... The formula might just as easily be tied to the profits of the Stilton Cheese industry. The link is illusory, misleading and designed to re-establish a relationship that is purely historic. It is worth noting that this plan was not dreamt up by the Treasury on its own and has the fingerprints of a certain senior Royal all over it. It also provides a clever way of frustrating the ambitions of the Scottish Government to devolve the administration and revenues of the Crown Estate.” [4]

In fact, in this, Andy Wightman is too generous to the Sovereign Grant Bill. When the Crown did receive the revenues from the Crown Estates, they were also responsible for running major functions of state, like defence. So historically, Crown Estate revenues were never used or intended solely for the upkeep of the monarchy: so it is misleading to imply that the present Bill is restoring any historic relationship.

Among other contributions to an analysis of the CEC handling of the Scottish Estate is the report of the working group of six local authorities in the Highlands and Islands and Highlands and Islands Enterprise. The report concluded: “There are relatively few public benefits in Scotland from the way these Scottish resources are managed at present, most notably the CEC’s management of Scotland’s territorial seabed and continental shelf rights and approximately half of Scotland’s foreshore. The very limited accountability in Scotland over the management of these Scottish resources has also become worse since devolution.”[2]

In the Press and Journal in September 2010, Brian Wilson wrote “In the early-1980s, it (the Crown Estate) blundered into my consciousness through its leasing of west-coast sea lochs to multinational salmon-farming companies without consulting anyone. Quite literally, people whose families had lived and worked in these places for generations woke up to find that the entire rights to use of a loch had been flogged off to Unilever or some such outfit. It was an astonishing saga that gave rise to decades of problems and resentments. So I became interested in the Crown Estate and concluded that its role as controller of Britain’s marine resources was an intolerable anomaly. Nothing has changed in the interim and there are now urgent reasons for the issue to be addressed.”

We now turn to a specific CEC activity which we have researched. This is the matter of CEC involvement in the ownership of Fort Kinnaird: a major retail development on the outskirts of Edinburgh.

In April 2007, the CEC and a company called the Hercules Unit Trust formed a £680 million joint venture limited partnership. The 50/50 partnership was named the Gibraltar Partnership Limited, and is an English limited partnership established under the Limited Partnership Act 1907. As a partnership, there is no need for accounts to be filed with Companies House. The joint venture incorporates three properties – the Fort Kinnaird Shopping Park in Edinburgh, which was owned by Hercules before the creation of the partnership, and was valued at £480 million, and two properties in England, owned by the Crown Estate before the partnership, and valued together at £200 million. The CEC saw the deal as “possibly the best example to date of how The Crown Estate has adapted and extended its reach in the last couple of years as part of

a plan to diversify our portfolio and balance our exposure to the central London property market.”

Clearly the value of the properties owned by the Crown Estate were significantly less than the value of the Fort Kinnaird property. The deal would therefore involve some complex financial transactions, and it is here that we need to give some further background information.

But first, it is important to clear up the status of the partnership that was set up as there is some confusion over the name “Gibraltar Limited Partnership”. There actually is a specific type of partnership called a "Gibraltar limited partnership": this type of partnership confers certain benefits including stamp duty land tax benefits. We asked the CEC specifically (a) is The Gibraltar Limited Partnership, the joint venture between the Commissioners of the Crown Estate and the Hercules Unit Trust, such a "Gibraltar limited partnership". And (b) is the Gibraltar General Partner Limited a "Gibraltar limited partnership". The CEC confirmed that neither was a Gibraltar limited partnership but that both were English limited partnerships.

As the CEC are charged with the management of public assets, it is important to have some background information on its chosen partner, that is, on Hercules Unit Trust. The Hercules Unit Trust (HUT) is a Jersey property unit trust which invests in properties in major retail warehouse or shopping park locations in the United Kingdom. It is 36.6% owned by British Land which is one of the UK’s largest real estate investment trusts. According to British Land, HUT is not an authorised unit trust scheme, OEIC or recognised scheme within the meaning of the Financial Services and Markets Act: it therefore constitutes an unregulated collective investment scheme. All or most of the protections provided by the UK regulatory system do not apply to investment in the HUT and compensation under the Financial Services Compensation Scheme is not available to investors. [5]

Further, unlike for a Jersey company or for a UK real estate investment trust, for a Jersey property unit trust there is no prohibition on financial assistance, no maintenance of capital rules, and no restrictions on distributions. It is possible to make distributions out of capital without the need to meet solvency or other tests. [6]

Note too that British Land, as well as being property advisor to Hercules, and a 36.6 per cent holder in the Hercules trust, acts as property adviser to the new limited partnership. The Gibraltar Partnership has its registered office at the offices of British Land.

As noted the CEC property contribution to the partnership was valued at £200 million. The CEC made an additional contribution in cash of £45 million. However, the Partnership also needed further funds to meet an outstanding debt of £200 million specifically on the Fort Kinnaird property. The funding to meet this debt was provided by the issue of Secured Floating Rate Notes due 2015 using the Emerald Funding (Gibraltar) Plc on the Irish Stock Exchange. Emerald Funding used the note issuance proceeds to advance a loan to Gibraltar General Partner Ltd. acting as general partner of The Gibraltar Limited Partnership. The advance was made under the terms of a loan agreement structured by Bank of America Securities Ltd. and secured on the

retail properties. Gibraltar General Partner Limited used the note proceeds to repay an existing facility of £200 million.

Effectively, therefore, the CEC was involved in a debt financed deal. Its share of the debt, financed by notes due for repayment in 2015, is shown directly in the CEC annual accounts as an outstanding “long term bank loan” of £100 million. So, although the CEC in terms of the 1961 Act are not allowed to borrow, the vehicle they used meant that they were indeed taking on debt.

By December 2008, Moodys, the credit rating agency, valued the retail parks at the reduced figure of £464.6 million compared to the original valuation of £680 million. However, among the covenants placed on the CEC by the Treasury, the amount of the loan drawn by the Gibraltar Partnership must not exceed 35% of the value of the partnership’s properties. The Partnership was therefore forced to place £37 million of cash as at March 2009 in a blocked account in order to maintain compliance with this covenant. This had risen to £55 million as at March 2010, that is, more than 25% of the loan has been sterilised, with the Partnership having to pay interest on it, but without being able to use these funds. As the Crown Estate noted in its Annual Accounts for 2009, “The largest writedowns in value have been the Gibraltar Limited Partnership, the only property interest which carries gearing”.

This chain of events raises a number of very interesting questions.

1. As we have seen, the effect of the deal is that CEC, who are statutorily barred from borrowing, have nevertheless acquired a significant amount of debt. CEC did get approval from the Treasury: the Treasury approved the transaction, with the caveat of the limitations on gearing ratio, but without officials going to Ministers. (House of Commons Treasury Committee The management of the Crown Estate Eighth Report of Session 2009–10 Volume II). Why did Treasury officials approve such a significant breach in the spirit of the 1961 Act, without taking Ministerial guidance?
2. The Gibraltar Limited Partnership has not filed any accounts with Companies House, and, since it is a limited partnership, actually has no requirement to do so. This means that it is impossible for members of the public to scrutinise what is going on with major assets of the Crown Estate. This lack of openness sits very ill with the role of the Crown Estate as “a form of public land managed by a public body for public benefit”. Why were the CEC allowed to place public assets in such an opaque partnership?
3. The methods used to set up the 50/50 partnership with Hercules Unit Trust may be standard practice in the private sector. However, it seems odd that a body entrusted with the management of public assets, of which in this case a substantial part was in Scotland, should use a newly constructed special purpose vehicle, Emerald, as the issuer of notes on the Irish Stock Exchange to raise the necessary finance to cover the partnership’s debt.
4. Although the Fort Kinneard joint venture was an important development in Scotland, there is nothing to suggest that the Secretary of State for Scotland knew what was happening, and he certainly did not give any direction to the

CEC on this deal even though it was within his statutory right to do so. The implication is that what should have been an important check and balance in the system is missing. Effectively, the current arrangement puts Scotland in a lose – lose situation. If the deal had been successful, and a large profit had been realised by the CEC, none of this would have come to Scotland. But on the other hand, if as a result of an unsuccessful deal the CEC find themselves in a position where they need to recoup their finances, then this means that they are likely to take a very hard-nosed view in order to maximise short term profits from other aspects of the management of the Crown Estate. But short term revenue maximisation may well be inconsistent with realising Scotland's long term economic potential of, for example, renewable energy developments. So, this raises the important question of why the Secretary of State for Scotland was not directly involved.

Overall, the situation we have outlined as regards Fort Kinnearde gives rise to considerable cause for concern. Looking to the future the implications are more serious. The big potential for Crown Estate activity is going to be sea bed revenues from various activities concerning the generation and transmission of renewable energy. If CEC become involved in joint ventures of the Fort Kinnearde type with regard to their sea bed activities, then this could move a large part of these activities out of proper public scrutiny, and could effectively amount to the back door privatisation of large parts of the sea bed. Moreover, if there is as little political oversight from Scotland as there was the Fort Kinnearde deal, then the process could be completely inimical to Scotland's interest in achieving sustainable economic development. It is time that the management of these public properties in Scotland returned to Scotland under the proper scrutiny of the Scottish Parliament.

This whole issue is given additional urgency because of the terms of the Sovereign Grant Bill which is currently going through Westminster. Tying the finances of the Royal Family to a share of Crown Estate profits will inevitably have an effect on the incentives of those who manage the Crown Estate – the temptation will be to maximise profits in order to stand in the good books of the Crown. Such a change in incentives could well see the Crown Estate Commissioners acting in a way which is even less mindful of their social responsibilities, and less mindful of the need to take a long term, rather than a short term, view. Given this, it is even more important that the whole matter of the Crown Estate, particularly in relation to Scotland, is sorted out.

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