

# The City of Edinburgh Council

10.00am, Thursday, 28 October 2021

## Edinburgh International Conference Centre hotel and hotel school – final business case

Executive/routine Wards Council Commitments	Executive 11 – City Centre <a href="#">2, 31</a>
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### 1. Recommendations

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- 1.1 It is recommended that the City of Edinburgh Council:
- 1.1.1 Agrees the final business case for the Edinburgh International Conference Centre (EICC) hotel and hotel school project (provided in Appendix 1);
  - 1.1.2 Agrees that the Council proceed with the EICC hotel and hotel school project on the terms set out in this report and the final business case;
  - 1.1.3 Notes that delegated authority would be granted to the Chief Executive (or any such other officer as they shall sub-delegate to) to proceed with the Agreement for Head Lease, the Agreement for Sub Lease, and any other agreements and actions required to commence the project;
  - 1.1.4 Notes that the Strategic Delivery Agreement (SDA) which would be entered into between the Council and EICC (as referenced in the final business case) is now provided at detailed Heads of Terms stage and that this will be reported to Housing, Homelessness and Fair Work Committee for consideration once developed into a full SDA covering both hotel and conference activities in January 2022; and
  - 1.1.5 Notes that EICC will submit, as part of the SDA, changes to it's governance and board composition in order to deliver this project and it's wider portfolio of business.

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## Edinburgh International Conference Centre hotel and hotel school – final business case

### 2. Executive Summary

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- 2.1 This report introduces a final business case for the Council entering into a 25-year head lease on a 349-bedroom hotel that is being developed at Haymarket Edinburgh by Quartermile Developments Limited for The Prudential Assurance Company Limited. The Council will in turn sub lease the hotel to Edinburgh International Conference Centre Limited (“EICC Ltd”), who will operate the hotel under a Franchise Agreement with the hotel brand Hyatt. The EICC will also operate a hotel school based in the hotel in partnership with Edinburgh College providing a unique training facility for students.
- 2.2 The profits from the hotel will in the first instance be used to fund the required capital investment in the Conference Centre. There is not expected to be any call on Council capital or revenue budgets and the Council will not take on any risk associated with the construction of the hotel.
- 2.3 A business case for the project was approved by the Finance and Resources Committee (and, subsequently, the City of Edinburgh Council) in March 2020, immediately prior to the rapid escalation of the COVID-19 outbreak in the UK. Since March 2020, officers have continued to develop the project and have now prepared a final business case as the negotiations with parties are largely complete and the Council will need to sign contracts over the coming weeks.
- 2.4 The final business case provides an updated position that reflects any changes in circumstances and the outcomes of the negotiations that have taken place. The business case’s findings are that the project continues to be viable and worthy of support and notes that additional benefits have been secured since March 2020. Importantly, discussions in relation to the proposed hotel school are now at an advanced stage and this element of the project is now likely to proceed, which will deliver much needed skills and training and ultimately employment opportunities for young people in the city.
- 2.5 The Council is now requested to approve the final business case, noting that the necessary authority would be delegated to the Chief Executive to enter into all agreements and take all actions required to deliver the project as per the original approval.

### 3. Background

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- 3.1 The Edinburgh International Conference Centre (“the Conference Centre”) is operated by EICC Ltd, a subsidiary of CEC Holdings Limited, which is a Council arm’s length company.
- 3.2 EICC Ltd forecasts that, over the 21-year period from January 2018 to December 2038, significant capital expenditure on the Conference Centre will be required. EICC Ltd’s operating surpluses are not forecast to be sufficient to meet this expenditure. A fund exists for investment in the Conference Centre, the Lothian Road Income Trust, but this is only capitalised with £2.2m. In June 2018, Housing and Economy Committee instructed officers to identify potential solutions to the capital funding challenge.
- 3.3 Council officers together with EICC Ltd officers identified a potential solution as being to secure (by lease or purchase) additional property with income-generation potential. Subsequently, the potential for the Council to lease a hotel which will be sub-let to EICC Ltd was explored. In spring 2019, the property developer Quartermile Developments Limited approached the Council with an opportunity for the Council to take a leasehold interest in a hotel being delivered at Haymarket Edinburgh, a brownfield development site on Morrison Street. It is important to note that the development will proceed regardless of whether the Council is involved – the Council is not itself developing a hotel, or financing the development of one, or enabling an otherwise unviable hotel to be developed via its involvement. However, the Council’s involvement is driving betterment of what would otherwise happen, for example by significantly boosting the carbon performance of the hotel building.
- 3.4 In October 2019, Finance and Resources Committee agreed the principle of the Council securing an interest in a hotel at Haymarket Edinburgh as a means of funding capital expenditure in the Conference Centre and instructed officers to carry out due diligence on the proposal. Officers subsequently developed a proposal, with elected members being given access to briefings and a data room in early-2020 to help inform them.
- 3.5 On [5 March 2020](#), a business case for the Council entering into a 25-year head lease on a hotel of around 365 bedrooms being developed at Haymarket Edinburgh by Quartermile Developments Limited and sub leasing the hotel to EICC Ltd to operate was presented to Finance and Resources Committee. The Committee agreed in principle to the Council proceeding with the project and referred the report to the City of Edinburgh Council to approve. The City of Edinburgh Council subsequently approved the report on [12 March 2020](#). Authority was delegated to the Chief Executive to enter into all agreements required to deliver the project including the Agreement for Head Lease and Agreement for Sub Lease.

#### **Project Status**

- 3.6 Following the decisions by Finance and Resources Committee and the City of Edinburgh Council in March 2020, officers began work to deliver the project.
- 3.7 During March 2020, the COVID-19 virus situation in the UK rapidly escalated.

- 3.8 In May 2020, in view of the potential detrimental impact of COVID-19 on the project, officers prepared a “gateway review” of the project for consideration by the Council’s Corporate Leadership Team. The key findings of the review were:
- 3.8.1 COVID-19 had had an extremely significant adverse impact on the city’s tourism sector, with occupancy and revenue per available room both believed to have fallen by more than the 20% figure below which the net present value of the project became negative, meaning that – at the time when the review was undertaken – the project was not viable;
  - 3.8.2 The Office for National Statistics and Office for Budget Responsibility forecast that the UK economy would contract by 12.8% in 2020 but grow by 17.9% in 2021 and resume its previously forecast growth trajectory from 2022;
  - 3.8.3 Consultancies generally predicted that the hotel market would recover by the end of 2021, caveated upon the absence of a second wave/second lockdown;
  - 3.8.4 The net present value of the project remained positive in two “downside” scenarios modelled by the Council’s Finance service;
  - 3.8.5 In the downside scenarios, the reserves of EICC Ltd and the Lothian Road Income Trust would be inadequate to meet shortfalls in the early years of the project, albeit this could be mitigated by deferring some capital expenditure; and
  - 3.8.6 Eight of the 15 key risks identified in the project’s risk register had been significantly exacerbated by COVID-19.
- 3.9 In December 2020, the Council commissioned Christie & Co to undertake an independent review of the project business case. Christie & Co recommended that financial projections be updated as recovery scenarios were judged to be “*likely to stretch into and beyond the estimated opening date of the proposed hotel*”. Christie & Co also noted that the net present value discount rate might have changed and suggested that the occupancy and average daily rate for the initial years were potentially overly optimistic given the impact of COVID-19; the longer-term stabilised occupancy rate was, however, still regarded as reasonable.
- 3.10 In April 2021, a second gateway review of the project was presented to the Corporate Leadership Team. The key findings of the review were:
- 3.10.1 Occupancy and revenue per available room in Edinburgh both fell sharply in 2020. Occupancy fell from 79.8% in July 2019 to 40.3% in July 2020, while RevPAR fell from £77.37 to £28.32 – reductions of 49.5% and 63.4% respectively, far greater than the 20% reduction modelled in the business case;
  - 3.10.2 Updated forecasts for the UK economy published by the Office for National Statistics and Office for Budget Responsibility in November 2020 suggested that, in the central scenario, the UK economy would return to its pre-COVID-19 (i.e. Q4 2019) size in Q4 2022. The upside scenario predicted Q4 2021;

- the downside scenario predicted Q4 2024 (but with the economy reaching 95% of its former size by Q4 2022);
- 3.10.3 The consultancy PwC predicted in October 2020 that revenue per available room in UK cities (including Edinburgh) would return to 2019 levels in 2023;
- 3.10.4 Negotiations with Quartermile Developments Limited and other key parties ongoing since March 2020 had resulted in a slightly improved proposition for the Council (as set out in the final business case);
- 3.10.5 EICC Ltd sustained an operating loss of £0.8m in the year ending 31 December 2020, with an overall loss of £1.7m, however, an operating profit of £0.25m is now forecast for the year ending 31 December 2021. EICC Ltd's cash reserves remain robust. EICC Ltd expect the domestic conference market to begin to recover from mid-2021 and the international conference market from 2022; and
- 3.10.6 Further downside modelling was carried out, this time based upon the tourism sector taking longer to recover than the UK economy overall. The project's net present value remained positive in this scenario. Due to improved commercial terms, the shortfalls in the early years of the project could now be met from a combination of EICC Ltd's reserves and the Lothian Road Income Trust even in the downside scenario.

## **4. Main report**

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- 4.1 Negotiations with the various organisations involved in the delivery of the project have advanced considerably since March 2020. Summary updates on each of the key commercial relationships are set out below:
- 4.1.1 The Agreement for Head Lease between The Prudential Assurance Company Limited and the Council is essentially complete and ready for signing. As set out in the final business case, the terms of the head lease have materially improved. Work has been carried out to help ensure the Council entering into the agreement with The Prudential Assurance Company Limited complies with all relevant regulations around procurement and state aid;
- 4.1.2 The Agreement for Sub Lease between the Council and EICC Ltd effectively mirrors the agreement for head lease and so is also essentially complete;
- 4.1.3 The Franchise Agreement between EICC Ltd and Hyatt is at an advanced stage and, as set out in the final business case, the financial terms have also been improved. There are several outstanding commercial points which at the time of writing EICC Ltd was in the process of agreeing with Hyatt, with a view to Hyatt formally approving the Franchise Agreement in October 2021;
- 4.1.4 The Head Leaseholder Agreement between Hyatt and the Council – which principally sets out the obligations upon each party in the event that the Council replaces EICC Ltd as operator of the hotel – has been agreed in

principle by both parties, with a view to Hyatt formally approving it in October 2021;

4.1.5 The Strategic Delivery Agreement between the Council and EICC Ltd setting out the Council's expectations and requirements of EICC Ltd vis-a-vis the hotel and hotel school is at detailed heads of terms draft stage and has been agreed in principle by the EICC Ltd Board; it will be reported to Housing, Homelessness and Fair Work Committee in January 2022 for approval. Further information is set out at 4.17; and

4.1.6 EICC Ltd has held extensive discussions with Edinburgh College around the operation of the hotel school and planning for this is now well advanced. The hotel school will be a long term arrangement that will provide excellent training opportunities for young people and importantly in the current climate will help to provide much needed talent to support the hospitality industry in Edinburgh. A business case on this aspect of the project is currently under consideration by the Scottish Government.

4.2 As a result of halts to non-essential construction work ordered in response to COVID-19, the expected practical completion date of the hotel (when the lease would come into effect) has been delayed to Quarter 3 in 2024. This revised programme has been factored into the final business case.

### **Final business case**

4.3 This report introduces a final business case (prepared using the HM Treasury "five case" model) for the Council entering into a 25-year lease on a hotel of 349 bedrooms<sup>1</sup> (the largest in Edinburgh) that is being developed at Haymarket Edinburgh by Quartermile on behalf of the owner and eventual landlord, The Prudential Assurance Company Limited. The Council will in turn sub lease the hotel to EICC Ltd, who will operate the hotel under a Franchise Agreement with Hyatt. The profits from the hotel will be used to help fund the required capital investment in the Conference Centre identified above. EICC Ltd will also operate a hotel school based in the hotel in partnership with Edinburgh College.

4.4 The final business case is broadly identical in structure to the business case presented to Committee in March 2020 but has been updated and refined to reflect the outcomes of the negotiations that have been carried out since then as well as the more detailed proposals for how the project will be delivered and the impact and implications of the COVID-19 pandemic. It continues to make a strong case for supporting the project and finds that, while the risk profile has changed and some additional costs have arisen, additional benefits have also been secured including additional restaurant and bar space (at no additional cost) and an improvement in the energy performance from a 'D' rating to a 'C' allowing the hotel to be heated without the use of gas, as well as financial benefits as outlined in the business case.

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<sup>1</sup> The number of bedrooms has reduced slightly due to amendments to the hotel design requested by EICC Ltd in order to enhance the food and drink offering of the hotel.

Importantly, it is still projected that there will be no call on Council for financial contribution to the hotel.

- 4.5 The final business case is to be considered as a private item given the commercially sensitive information it contains. It has been prepared by Council officers with input and oversight from EICC and from specialist hotel consultants.
- 4.6 The Strategic Case chapter of the business case sets out the strategic rationale for proceeding with the project. The project aims to deliver six key benefits for the Council and for Edinburgh more widely: funding capital expenditure on the Conference Centre; generating an additional return on investment (profit); making EICC Ltd financially self-sufficient; enhancing the skills of tourism sector workers; contributing to the strategic development of Haymarket Edinburgh; and attracting additional visitor expenditure to Edinburgh. The project will contribute to the fulfilment of five outcomes set out in the Council's Business Plan and multiple strategic aims, including the Edinburgh Economy Strategy, Edinburgh Tourism Strategy, and the 2030 net zero carbon target, for example by creating over 200 new jobs paying at least the Real Living Wage (making it an exemplar for well-paid, fair work) and reducing the expected carbon emissions of the proposed hotel. The activities of EICC added £720m to the economy of Edinburgh in the year ending 31 December 2019; the project will enable this impact to be increased.
- 4.7 The Economic Case chapter of the business case sets out the two options for delivering the project that were considered (along with the "do nothing" option) and the net present value and wider benefits of each, concluding that a Franchise Agreement delivers the best value, with a positive net present value. Sensitivity analysis shows that the projected net present value remains positive under adverse market conditions up to a simultaneous decline in occupancy and room rate of 20%. The Economic Case chapter also sets out that Haymarket Edinburgh was judged to be the only available location for the hotel fulfilling the requirements of close proximity to the Conference Centre, capacity of 350–400 bedrooms, and the ability to generate required profits in the required timeframe.
- 4.8 The Financial Case chapter of the business case models the costs and income of the hotel, including maintaining a reserve to cover lifecycle expenditure on the hotel. Costs during the pre-opening phase of the hotel (such as construction management, staff recruitment and the purchase of hotel supplies) will be met from EICC Ltd's cash balances, which will subsequently be replenished once the hotel is operational. In its first year of trading the hotel is projected to generate sufficient revenue to, when combined with key money received from the franchisor<sup>2</sup>, enable the hotel to meet projected running costs, pay taxes due, and to reinstate EICC Ltd's cash balances. In the longer-term, as revenues reach stabilisation, the projected profits will enable the capital expenditure requirements of the Conference Centre to be met in full and to build up a contingency reserve. Surpluses beyond this will be available for redistribution to the Council and, upon agreement,

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<sup>2</sup> Key money refers to an upfront payment made by a hotel brand as a financial inducement to secure a franchise / management agreement. This payment is returnable should EICC Ltd cease to comply with the terms of the agreement.

reinvestment in EICC Ltd. The hotel will remain profitable in most forecast scenarios albeit it could not sustain a deep prolonged fall in demand. There is not expected to be any call on Council capital or revenue budgets for the duration of the project. Instead, the projections are that the EICC will become fully financially self-sustaining and that dividends could be paid to the Council in future years.

- 4.9 The Commercial Case chapter of the business case sets out how commercial relationships will be established in a manner that secures best value and at the same time ensures compliance with relevant legal and regulatory rules, including procurement rules. The Council will directly enter into a head lease agreement for the hotel to be developed, with the hotel being leased to the Council when construction is complete. The Council entering into such an arrangement is permitted under the relevant regulations, and commercially the only option, on the basis that Haymarket Edinburgh is the only possible site meeting the requirements of the Council and EICC Ltd: (i) close proximity to the Conference Centre, (ii) a capacity of 350–400 bedrooms, and (iii) the ability to generate the required profits within the required timeframe. This approach has been subject to independent assessment by the Council’s external legal and property advisers. The sub lease of the hotel to EICC Ltd will be on market terms mirroring those of the head lease entered into by the Council. EICC Ltd will then operate the hotel under a Franchise Agreement with the hotel brand Hyatt, which was identified as the preferred franchise partner selected following an extensive selection process. The Commercial Case has been revised and updated to reflect actual and pending regulatory changes in the wake of the UK’s departure from the European Union.
- 4.10 The Management Case chapter of the business case sets out how the project will be governed and managed. From the Council’s perspective, the core relationship of the project is that between the Council and EICC Ltd, and this will be controlled by three key documents: the EICC Ltd shareholders’ agreement, the sub lease, and a new Strategic Delivery Agreement between the Council and EICC Ltd. A programme and risk register have been prepared. A framework has been developed for the management of the development of the hotel, for health and safety management, and for remedial actions in the case of construction insolvency, along with cost, risk, stakeholder, communications, environmental, and benefits management. EICC Ltd has set out how the hotel and the hotel school will be structured and operated.
- 4.11 The business case concludes that the project aligns with the Council’s strategic aims; that the project secures best value and represents the best of the options available; that the project is affordable and fundable; that the project is commercially viable and can be procured in line with relevant regulations; and that the Council and EICC Ltd can successfully deliver the project.

#### **Strategic Delivery Agreement (SDA)**

- 4.12 An SDA is now at a detailed heads of terms draft stage and has been agreed in principle by the EICC Ltd Board but this currently only covers the hotel element of the overall EICC business. These provisions for the hotel are considered by officers to be suitably robust reflecting the fact that the Council is also the majority



shareholder of the company. This will be developed into a full SDA covering the overall business of the EICC (conference and hotel) The detail of this will be reported to Housing, Homelessness and Fair Work Committee for agreement in January 2022. Thereafter the matter will be reported back to Council for final agreement including any adjustments to the Shareholders Agreement. It should be noted that the Council may in due course want to consider the make-up of the board given the growing remit of the company.

- 4.13 Given that the Council has control of EICC Ltd, it is acceptable for this process to continue after the Franchise Agreement, hotel leases and other necessary agreements have been signed as this is solely an internal matter for the Council and EICC Ltd to agree and does not impact upon commercial relationships with third parties, nor will it delay the project.
- 4.14 Given the widening of operations that this project represents, and for good governance purposes, it has been agreed at a recent EICC Board meeting that the overall structure of the Board including the formation of various committees is to be reviewed with a view to producing remits and standing orders for each of the committees that are set up. This work should also include the remit and number of independent non-Executive Directors required for the future and these matters will also be included in the SDA.

## **5. Next Steps**

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- 5.1 Subject to approval by full Council, the Council will enter into the Agreement for Head Lease with The Prudential Assurance Company Limited, the Agreement for Sub Lease with EICC Ltd, and all other agreements needed to deliver the project as set out in the associated final business case.
- 5.2 A full project programme is set out in Annex C of the associated final business case.
- 5.3 Project updates will be provided via annual reports and business bulletin items along with EICC Ltd's annual reports.

## **6. Financial impact**

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- 6.1 The report recommends that the Council approves the principle of the Council entering into a head lease agreement on the hotel and into a sub-lease agreement with EICC Ltd that will mirror the terms of the head lease. Financial modelling carried out to support the business case shows that the hotel will generate sufficient profits to meet rental payments in full.
- 6.2 The hotel is expected to be profitable from its first year of operation, bolstered by improved financial terms secured through negotiation with the landlord and franchisor. There will be additional costs for EICC Ltd during the pre-opening phase,

but these will be covered by EICC Ltd's cash reserves. There is therefore not expected to be any call on Council capital or revenue budgets.

- 6.3 It is forecast that the hotel will deliver sufficient net surpluses over the project lifespan – covering around two years pre-opening and 25 years of operations – to fund the Conference Centre lifecycle capital expenditure over that period and build up a contingency reserve. The use of residual surpluses remaining after funding capital expenditure on the Conference Centre and other agreed priorities (such as required capital expenditure on the hotel) will be subject to discussions between EICC and the Council.
- 6.4 There is a risk that the profitability of the hotel could be eroded by adverse market conditions. A range of scenarios have been tested and it has been found that the hotel could remain viable given adverse market conditions of as much as a 20% decline in occupancy alongside a 20% decline in room rate for the full duration of the 25-year lease period. The hotel could not sustain prolonged extremely adverse market conditions such as those seen during the COVID-19 pandemic.
- 6.5 The proposal for the hotel school between the EICC and Edinburgh College is still under development but is now at an advanced stage. It is projected that the costs of running the school can be met via fees paid by Student Awards Agency Scotland. A separate business case has been submitted to the Scottish Government and Scottish Futures Trust regarding potential additional funding to support the hotel school.

## **7. Stakeholder/Community Impact**

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- 7.1 The principal project stakeholders and the strategy for managing good relations with each are set out in the Management Case chapter of the associated business case.

## **8. Background reading/external references**

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- 8.1 [Edinburgh International Conference Centre Hotel and Hotel School – Business Case](#) – report to the Finance and Resources Committee, 5 March 2020.

## **9. Appendices**

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- 9.1 Appendix 1: Edinburgh International Conference Centre hotel and hotel school – final business case (restricted document)