Matter 5 Hearing Statement
3016 words including Inspector's questions

Delivery Mechanisms and State Aid

This hearing statement focuses on new issues arising since the consultation closed on 30th September.

We only now have access to NEGC's Avison Young[1] appraisal which provides significant new information on the NEAs' delivery plans and highlights the need to understand the corporate structure.

We explore some alternative structures in answer to the questions below and specifically address the Avison Young report in the Appendix[2].

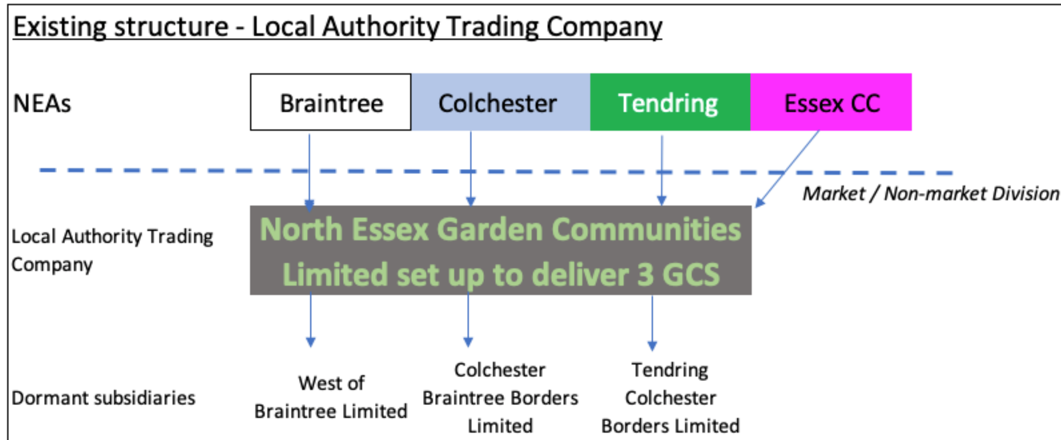
5. (a) If the Section 1 Plan is neutral as regards who will be responsible for leading delivery of the proposed garden communities, how will the NEAs be able to ensure through their development management powers that any garden community proposal that comes forward meets all their policy aspirations for the garden communities?

The absence of an agreed delivery structure which clarifies responsibilities, risks and rewards is a fundamental risk to the Plan. The NEAs need to demonstrate convincingly that there is at least one structure that works otherwise the Plan cannot be deliverable or sound.

The four delivery structures listed below have all been discussed at various times – the Avison Young structure is closest to Alternative 2. We hope that the diagrams will be helpful.

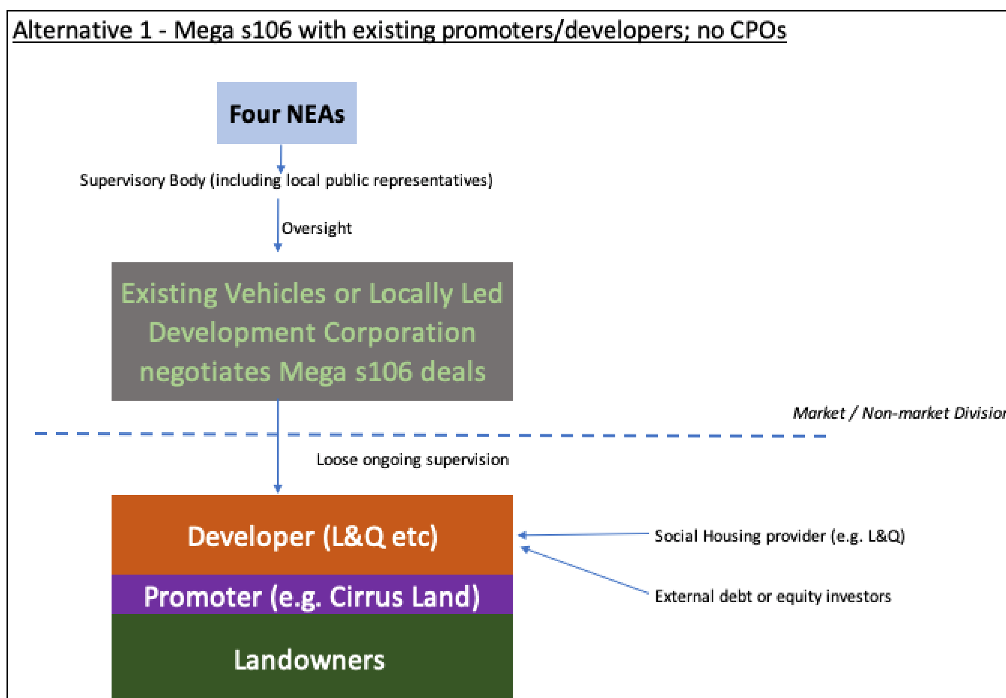
[1] The Avison Young viability evidence by NEGC Ltd. on 30th September 2019. We asked for sight of it earlier but it was still submitted at the last possible opportunity. This is the first time we have been able to comment on it. Our full critique is available on the CAUSE website.
[2] An extract from CAUSE's commentary on the Avison Young report is included as an appendix to ths paper. The full commentary is available on the CAUSE website.

Existing structure



The existing Local Authority Trading Company ("LATC") has no special powers (CPO or planning) and no land on which to secure borrowing. It is entirely dependent on the NEAs for funding (which would need to be at MEOP rates to be State Aid compliant). According to our legal advice there are potential further complications from NEGC's LATC status. We believe the NEAs acknowledge that this is not a practical delivery structure to purchase land and engage in a Master Developer capacity.

Alternative 1



Alternative 1 envisages private sector led development. We question whether this is realistic. There is no evidence that stockmarket-quoted developers such as Urban & Civic or U+I have the financial strength for a project on the scale of West Tey. L&Q has a strong balance sheet, but it is a housing association whose normal role is to buy social housing from developers and manage it on a long-term basis. Although involved in a number of large schemes it is not a specialist developer. We question whether it has the risk appetite for the "lead role" on such a complex long-term scheme, especially in view of its recent withdrawal from new projects[3], and this applies to any other developer.

There will also be an imbalance of power in the s106 negotiations. Once the plan is adopted the Master Developer will be in an almost inalienable position. Viability appraisals will be produced over the years to show that the infrastructure can't be delivered[4] and the downside risk will be left with the public. The NEAs would in reality have little ability to influence the project. The Savills appraisal prepared for L&Q already suggests that infrastructure spending including fees and contingency can be cut from £1.2 billion in Hyas to £777m: and housebuilding costs from £177k per dwelling to £102k.

Welborne provides a case study. There Buckland Developments controls the land and has secured planning permission for 6000 dwellings with only 10% social housing in phase 1. They have negotiated a review mechanism for later phases which entitles them to £100,000 per acre on their land: base + 5.25% interest on their landholding and build costs and a 20% developer's margin. This structure transfers very little risk to the private sector[5] other than for the first 1000 units. Buckland holds all the cards.

Furthermore, we believe (and our viability work shows) that putting aside any erosion of infrastructure promises over time, the projects are indeed not viable at private sector finance rates. Any suggestion of Government/NEA subsidy (directly or via "cheap" financing) to mitigate the issues identified above would immediately risk running into difficulty under the State Aid rules.

State Aid rules will also apply to the HIF bids. MHCLG make it clear that the Local Authorities need to address any state aid problems. The HIF bids directly link funding for roads to selected sites, thus using government subsidy to interfere in a number of markets including those for development land, master planning and housing. The NEAs will have difficulty demonstrating why they had to choose those specific sites when equally suitable ones were available (see Additional Sustainability Appraisal).

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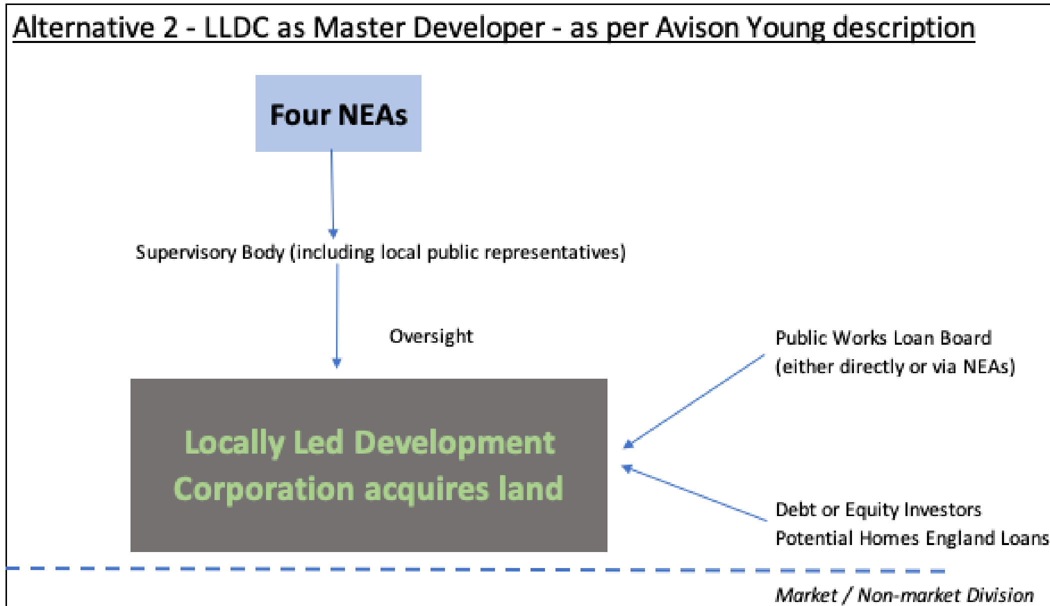
[3] Inside Housing September 19 quotes David Montague, chief executive at L&Q as saying: "We have already slowed our development programme and will now pause taking on new projects for the moment". It is clear that L&Q's recent financial results have been disappointing and that it has major refurbishment works on its properties to work on following the fire at Grenfell Towers.

[4] The Savills report prepared for L&Q shows that this is already the case. Infrastructure is cut back to £777m and delayed while developer profit escalates to £1.3billion.

[5] See CBRE report for Fareham Borough Council October 2019

Alternative 2



Alternative 2 leaves the LLDC firmly in the public sector. It is the closest to the structure implicitly assumed by Avison Young who state in para 33 that "The finance rates adopted by Grant Thornton are in line with the rates that are used for projects to be carried out by state enterprises such as a LLDC" (our emphasis). The following issues arise:

- Public sector takes all the risk and reward by financing land acquisition but possibly relying on private sector development at points further down the "chain"
- The LLDC is far from exempt from State Aid problems – indeed a number of markets are affected. With onwards finance needing to be MEOP compliant, we believe that viability is little better than in other structures
- Indeed CPO is as much a complicating factor as a potential viability mitigant: it is unclear if CPO is feasible (see Carter Jonas questions and (6) below); all land must be CPOed (cannot "mix and match" paying some landowners prices better than others); CPO over the long term in small parcels is unproven and problematic (hope value implications etc); it is hard to see CPO as not ultimately driving long delays and – ironically – delivery risk
- State aid rules will also apply to the HIF bids as in Alternative 1 above
- The Supreme Court judgement in Wright v Forest of Dean may also cause problems[6]. Planning authorities are meant to make decisions on planning grounds, not from a desire for other benefits such as profits from interest

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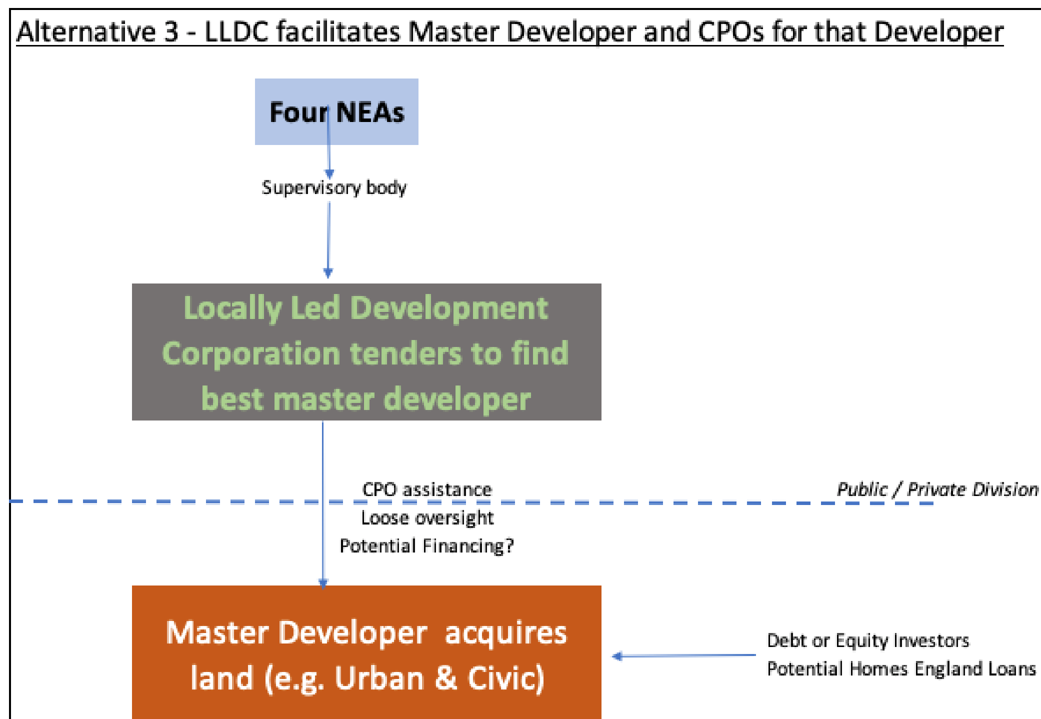
farming (necessary to comply with MEOP) or the desire to attract HIF money to the area which is covered in our Matter 7 hearing statement.

Alternative 3



Alternative 3 envisages a public sector development corporation exercising its CPO powers for the benefit of an appointed master developer. Problems include:

- The time taken to prepare a development brief and select a Master Developer during which unwelcome planning applications could be received
- The likelihood that little risk will be transferred to the private sector – Alconbury for example has just 12.5% social housing to be increased only if IRR exceeds 20%
- The cost and legal complexity of adding an extra layer – the LDDC will incur operating costs of £210m[7] over the project lives in the AY model, and this will inevitably be increased by the cost of documenting and policing the contractual relationship.
- The tax inefficiency of an extra layer[8].
- The project will still have a private sector cost of capital, CPO will still be complex and the state aid rules will still apply. It is difficult to see how it would be viable.

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[7] £77m for WOB, £89m for CBB, £44m for TCB

[8] It may be possible to side-step double SDLT with building licenses rather than land sale: but banks like security over an interest in land and building licenses are therefore difficult for housebuilders to finance, particularly in recessions funding is scarce.

(b) In this regard, do any further amendments need to be made to policy SP7 paragraph 3 (beginning "The Councils will need to be confident ...") and/or to policy SP7 criterion (ii)?

This policy needs to be strengthened to prevent tailgating – unwelcome applications received before the NEAs are ready with their own implementation plans. Every promise made during the public consultations must be hard wired into the plan with specific reference to the Garden Community principles and up-front infrastructure.

(c) Should the Section 1 Plan instead specify that delivery of the proposed garden communities should be led by a public-sector local delivery vehicle, a Locally Led New Town Development Corporation, or a private-sector developer?

After 4 years and the expenditure of £7.6m on fees there should be one clear and agreed delivery mechanism. Without one it appears that the NEAs are not so much delivery vehicle blind as unable to find a structure that will deliver. We question how a 'delivery blind' plan can be deemed sound, especially given that each of the proposed delivery methods is fraught with unresolved problems.

6. (a) Would the existence of a viable alternative master developer with control over land allocated for a garden community restrict the ability of the Secretary of State to confirm a CPO on that land (see paragraphs 8.10-8.11 of the consultation response to EB/084 from Carter Jonas on behalf of L&Q, Cirrus Land Ltd and Gateway 120)?

Yes it would restrict the ability of the SoS to confirm a CPO. It is difficult to prove that CPO serves the public interest when the existing owners want to do much the same thing. The main justification would have to be land value capture for the provision of infrastructure, but this is tantamount to taxation by another name which would require Parliamentary approval.

In particular the L&Q proposals for West Tey will make it hard to comply with paras 143 and 144 of the CPO Guidance. There will be similar difficulties for WOB and TCB where there have also been private sector led housing proposals for many years.

The long history of other schemes on the GC sites will significantly add to their "no scheme" hope value. We do not agree with the statement in para 12 of ED084 that the land is "In the absence of the garden community scheme most of the land is not developable in the foreseeable future". Much of the land is highly developable in the absence of the scheme, as demonstrated by the speculative applications rife in Braintree and Tendring District (and already to a lesser extent in Colchester). Paragraph 12 appears to be a (hollow) negotiating position.

We have asked NEGC for a copy of the Avison Young CPO report referred to in paras 18,19 and 43 of their consultation response because it is fundamental to their

viability evidence. Further difficulties with CPO are explored in chapter 4 of the CAUSE consultation response.

(b) If so, what are the implications for delivery of the garden communities in accordance with the NEAs' policy aspirations?

Undeliverable (though we believe CPO still does not "unlock" viability).

Appendix

NEGC’s Consultation response on Viability

Extract from CAUSE’s commentary on the Avison Young report
28nd November 2019

Summary

The Avison Young report claims to demonstrate that the GC plan is financially viable by utilising an “LLDC” structure[9]. But it actually achieves almost exactly the opposite. In particular:

- Its new output (IRR) is potentially better[10] than the Hyas approach to evaluating long term projects, but IRR must be compared to the whole cost of capital, not just the cost of debt.
- Its new input (CPO land values) is opaque. The report from AY’s CPO team needs to be made public. Furthermore, there would need to be careful testing around key assumptions underlying the CPO analysis (e.g. with regard to the important input of potential for alternative development, where using the Dentons advice in EB084 the whole report is premised on input from the NEAs which of course is not appropriately objective).
- Cost of Capital is a vital topic which Avison Young have surprisingly failed to address. The cost of debt used by them explicitly[11] reflects government support, but an LLDC would be no less problematic a structure than any other for State Aid (see CAUSE Matter 5 Hearing Statement). The cost of capital must also reflect the cost of equity or any equity-like component of structure such as a guarantee. Even if an LLDC is borrowing from government (albeit at MEOP rates for State Aid compliance), it would need to be the case either that those MEOP rates reflect a 100% Debt structure (which would increase them significantly) or there would potentially need to be an equity component to reduce the risk profile ascribed to the borrowing. Note in this context that current legislation requires LLNTDCs to demonstrate a suitable return to justify borrowing, which is clearly an Equity-type concept.
- It falls into similar traps on contingencies, delivery rates and inflation as Hyas. All of these items have a huge impact on viability because the economics are very sensitive to the size of the early phase infrastructure costs. Like Hyas, Avison Young provide no meaningful sensitivities which attempt to address

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[9] Locally Led new town Development Corporation as per Avison Young para 11.

[10] It is better than the Hyas IRR calculation which is simply a circular reference to the inputted cost of debt, plus an adjustment for master developer profit; it is also potentially better than the residual value approach which here risks comparing future values with present ones for projects which have relatively unique characteristics of the land not being owned upfront. We have also seen examples of professional firms (Hyas in 2017, Gerald Eve and Troy Three Dragons) omitting interest on land costs despite specific warnings in the Harman guidelines; this error is not made in the Avison Young analysis, **but the cost of debt used appears to be far too low**.

[11] See para 33 of Avison Young report

the potential risk profile underlying these large, long-term projects which utilise virtually unprecedented structures.

- The words are inconsistent with the numbers and the conclusions are therefore not to be relied upon. We would like to see Grant Thornton's conclusions from the same numbers, with a comparison to those in the redacted part of the important December 2016 PWC report[12]
- The report concludes that the Garden Communities are viable and deliverable, but the numbers show exactly the opposite. The table below lists the Avison Young IRRs: we mark anything below 10% + inflation as red - unviable. Results marked amber are at the "margins of viability" and should not be assumed to be deliverable[13]. Only IRRs of 3% above the threshold should be marked green as viable and therefore deliverable. Our choice of these thresholds is explained below.

Avison Young IRRs compared to threshold

	Threshold based on PWC report	WOB	CBB	TCB
300 DPA no inflation	10.0%	5.39%	3.59%	8.20%
300 DPA 0.5% inflation	10.5%	6.90%	5.30%	10.00%
300 DPA 1% inflation	11.0%	8.37%	6.81%	11.65%
500 DPA no inflation	10.0%	8.00%	1.70%	10.30%
500 DPA 0.5% inflation	10.5%	10.30%	1.09%	12.57%
500 DPA 1% inflation	11.0%	12.55%	5.50%	14.74%

Note: These IRRs are based on the AY assumptions which we regard as too optimistic by far, particularly on contingency and land purchases. We have no doubt that all cases would turn red if realistic assumptions were included in just these two areas.

Choice of IRR Threshold

Two reports[14] provide support for a much higher IRR viability threshold:

1. The 2016 PWC report, which points out that the cost of capital must include not just the cost of debt but also the cost of equity or guarantee fees charged on an arms-length basis. With no guarantee the cost of debt would carry a margin of up to 10%[15] which has to be added to a base rate. This figure should, in financial theory[16], stay at the same level for different capital structures whether the level of debt is high or low, and whether the equity risk

[12] We know that there are appraisal numbers in the PWC report because some Councillors have been allowed to see it.

[13] Harman Guidance page 16 "Given the clear emphasis on deliverability within the NPPF, Local Plan policies should not be predicated on the assumption that the development upon which the plan relies will come forward at the 'margins of viability". .

[14] Further evidence is provided by the Uraban & Civic s106 agreement for Alconbury where a 20% IRR is the threshold for increasing the social housing percentage above 12.5%. 20% is clearly regarded as an acceptable return for the master developer.

[15] See PWC report 16 December 2016 page 23

[16] The Miler/Modigliani theorem which is applied on a pre-tax basis in line with all the GC models.

is born by a guarantor charging a guarantee fee or an equity investor expecting dividends and capital growth.

2. The CBRE report[17] prepared for Fareham Borough Council re Welborne Garden Village which states on page 25 that "On strategic sites a key measure of viability is the IRR which should, ideally be, circa 12%+."

We suggest that a minimum viability threshold of 10% + inflation[18] should be adopted, at least until a proper WACC study has been done[19]. Given inflation expectations at around the BoE 2% guideline, this is broadly in line[20] with both the PWC report and CBRE's estimate.

Anything just above the minimum should be regarded as "at the margins of viability, and, as per the Harman guidance, should not be relied upon. We suggest that anything within 3% of the minimum is "at the margins of viability" and anything above is potentially viable.

The paper goes on to consider cost of capital in more detail and other aspects of the AY paper. The full paper is available on CAUSE's website

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30th November 2019

[17] https://moderngov.fareham.gov.uk/documents/s23065/Appendix%20B%20-%20Welborne%20Viability%20Review%20-%20Edited.pdf

[18] AY agree that inflation should be added – see para 12 "In such cases the target IRR is increased to account for the level of growth/inflation being applied."

[19] A proper Weighted Average Cost of Capital study might be based on the Capital Asset Pricing Model, starting with the risk free rate and pricing in risk premia at market rates.

[20] The threshold including 2% inflation is 12% which is very close to the PWC figure of 10.75% including .75% base rate or 20 year swap rate.